CODE OF FEDERAL REGULATIONS

Title 26

Internal Revenue

Part 1 (§§ 1.0 to 1.60)

Revised as of April 1, 2018

Containing a codification of documents
of general applicability and future effect

As of April 1, 2018

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To cite the regulations in this volume use title, part and section number. Thus, 26 CFR 1.0–1 *refers to title 26, part 1, section 0–1.*

Explanation

The Code of Federal Regulations is a codification of the general and permanent rules published in the Federal Register by the Executive departments and agencies of the Federal Government. The Code is divided into 50 titles which represent broad areas subject to Federal regulation. Each title is divided into chapters which usually bear the name of the issuing agency. Each chapter is further subdivided into parts covering specific regulatory areas.

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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The Paperwork Reduction Act of 1980 (Pub. L. 96–511) requires Federal agencies to display an OMB control number with their information collection request.

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What is incorporation by reference? Incorporation by reference was established by statute and allows Federal agencies to meet the requirement to publish regulations in the Federal Register by referring to materials already published elsewhere. For an incorporation to be valid, the Director of the Federal Register must approve it. The legal effect of incorporation by reference is that the material is treated as if it were published in full in the Federal Register (5 U.S.C. 552(a)). This material, like any other properly issued regulation, has the force of law.

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An index to the text of ''Title 3—The President'' is carried within that volume.

The Federal Register Index is issued monthly in cumulative form. This index is based on a consolidation of the ''Contents'' entries in the daily Federal Register.

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OLIVER A. POTTS,
Director,
Office of the Federal Register
April 1, 2018

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, 2018. 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, Cheryl E. Sirofchuck 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, §§1.0 to 1.60)

CHAPTER I—INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY

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

SUBCHAPTER A—INCOME TAX

SUPPLEMENTARY PUBLICATIONS: *Internal Revenue Service Looseleaf Regulations System, Alcohol and Tobacco Tax Regulations,* and *Regulations Under Tax Conventions.*

EDITORIAL NOTE: Treasury Decision 6091, 19 FR 5167, Aug. 17, 1954, provides in part as follows:

PARAGRAPH 1. All regulations (including all Treasury decisions) prescribed by, or under authority duly delegated by, the Secretary of the Treasury, or jointly by the Secretary and the Commissioner of Internal Revenue, or by the Commissioner of Internal Revenue with the approval of the Secretary of the Treasury, or jointly by the Commissioner of Internal Revenue and the Commissioner of Customs or the Commissioner of Narcotics with the approval of the Secretary of the Treasury, applicable under any provision of law in effect on the date of enactment of the Code, to the extent such provision of law is repealed by the Code, are hereby prescribed under and made applicable to the provisions of the Code corresponding to the provision of law so repealed insofar as any such regulation is not inconsistent with the Code. Such regulations shall become effective as regulations under the various provisions of the Code as of the dates the corresponding provisions of law are repealed by the Code, until superseded by regulations issued under the Code.

PAR. 2. With respect to any provision of the Code which depends for its application upon the promulgation of regulations or which is to be applied in such manner as may be prescribed by regulations, all instructions or rules in effect immediately prior to the enactment of the Code, to the extent such instructions or rules could be prescribed as regulations under authority of such provision of the Code, shall be applied as regulations under such provision insofar as such instructions or rules are not inconsistent with the Code. Such instructions or rules shall be applied as regulations under the applicable provision of the Code as of the date such provision takes effect.

PAR. 3. If any election made or other act done pursuant to any provision of the Internal Revenue Code of 1939 or prior internal revenue laws would (except for the enactment of the Code) be effective for any period subsequent to such enactment, and if corresponding provisions are contained in the Code, such election or other act shall be given the same effect under the corresponding provisions of the Code to the extent not inconsistent therewith. The term ''act'' includes, but is not limited to, an allocation, identification, declaration, agreement, option, waiver, relinquishment, or renunciation.

PAR. 4. The limits of the various internal revenue districts have not been changed by the enactment of the Code. Furthermore, delegations of authority made pursuant to the provisions of Reorganization Plan No. 26 of 1950 and Reorganization Plan No. 1 of 1952 (as well as redelegations thereunder), including those governing the authority of the Commissioner of Internal Revenue, the Regional Commissioners of Internal Revenue, or the District Directors of Internal Revenue, are applicable to the provisions of the Code to the extent consistent therewith.

SUBCHAPTER A—INCOME TAX

PART 1—INCOME TAXES

RESEARCH CREDIT—FOR TAXABLE YEARS BEGINNING BEFORE JANUARY 1, 1990

RULES FOR COMPUTING CREDIT FOR INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY

RULES FOR COMPUTING CREDIT FOR EXPENSES OF WORK INCENTIVE PROGRAMS

TAX SURCHARGE

REGULATIONS APPLICABLE TO TAXABLE YEARS BEGINNING IN 1969 AND ENDING IN 1970

TAX PREFERENCE REGULATIONS

AUTHORITY: 26 U.S.C 7805, unless otherwise noted.

Section 1.1(h)–1 also issued under 26 U.S.C. 1(h);

Section 1.21–1 also issued under 26 U.S.C. 21(f);
Section 1.21–2 also issued under 26 U.S.C. 21(f);
Section 1.21–3 also issued under 26 U.S.C. 21(f);
Section 1.21–4 also issued under 26 U.S.C. 21(f);
Sections 1.23–1—1.23–6 also issued under 26 U.S.C. 23;
Section 1.25–1T also issued under 26 U.S.C. 25;
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Section 1.41–6 also issued under 26 U.S.C. 1502;
Section 1.41–8 also issued under 26 U.S.C. 41(c)(4)(B);
Section 1.41–8T also issued under 26 U.S.C. 41(c)(4)(B);
Section 1.41–9 also issued under 26 U.S.C. 41(c)(5)(C);
Section 1.41–9T also issued under 26 U.S.C. 41(c)(5)(C);
Section 1.42–1 also issued under 26 U.S.C. 42(n);
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Section 1.42–5 also issued under 26 U.S.C. 42(n);
Section 1.42–5T also issued under 26 U.S.C. 42(n);
Sections 1.42–6, 1.42–8, 1.42–9, 1.42–10, 1.42–11, and 1.42–12, also issued under 26 U.S.C. 42(n);
Section 1.42–10T also issued under 26 U.S.C. 42(n);
Section 1.42–13 also issued under 26 U.S.C. 42(n);
Section 1.42–14 also issued under 26 U.S.C. 42(n);
Section 1.42–15 also issued under 26 U.S.C. 42(n);
Section 1.42–16 also issued under 26 U.S.C. 42(n);
Section 1.42–17 also issued under 26 U.S.C. 42(n);
Section 1.42–18 also issued under 26 U.S.C. 42(h)(6)(F) and 42(h)(6)(K);
Sections 1.43–0—1.43–7 also issued under section 26 U.S.C. 43;
Section 1.45D–1 also issued under 26 U.S.C. 45D(e)(2) and (i);
Section 1.46–5 also issued under 26 U.S.C. 46(d)(6) and 26 U.S.C. 47(a)(3)(C);
Section 1.46–6 also issued under 26 U.S.C. 46(f)(7);
Section 1.47–1 also issued under 26 U.S.C. 47(a);
Section 1.48–9 also issued under 26 U.S.C. 38(b) (as in effect before the amendments made by subtitle F of the Tax Reform Act of 1984);
Sections 1.50A—1.50B also issued under 85 Stat. 553 (26 U.S.C. 40(b));
Section 1.52–1 also issued under 26 U.S.C. 52(b);
Section 1.56–1 also issued under 26 U.S.C. 56(f)(2)(H);
Section 1.56(g)–1 also issued under section 7611(g)(3) of the Omnibus Budget Reconciliation Act of 1989 (Pub. L. 101–239, 103 Stat. 2373); and
Section 1.58–9 also issued under 26 U.S.C. 58(h).

EFFECTIVE DATE NOTE: At 83 FR 13184, Mar. 28, 2018, the authority citation for part 1 was amended by revising the sectional authority entities for §§1.41–6 and 1.280C–4 and adding a sectional authority for §1.45G–1 in numerical order to read in part as follows, effective Apr. 2, 2018.

AUTHORITY: 26 U.S.C 7805 * * ** * * * *Section 1.41–6 also issued under 26 U.S.C.41 (f)(1) and 1502.* * * * *Section 1.45G–1 also issued under 26 U.S.C. 45G(e)(2)* * * * *Section 1.280C–4 also issued under 26 U.S.C. 280C(c)(4)* * * * *

SOURCE: T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960, unless otherwise noted.

§ 1.0–1 Internal Revenue Code of 1954 and regulations.

(a) *Enactment of law.* The Internal Revenue Code of 1954 which became law upon enactment of Public Law 591, 83d Congress, approved August 16, 1954, provides in part as follows:

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That

(a) *Citation.* (1) The provisions of this Act set forth under the heading ''Internal Revenue Title'' may be cited as the ''Internal Revenue Code of 1954''

(2) The Internal Revenue Code enacted on February 10, 1939, as amended, may be cited as the ''Internal Revenue Code of 1939''.

(b) *Publication.* This Act shall be published as volume 68A of the United States Statutes at Large, with a comprehensive table of contents and an appendix; but without an index or marginal references. The date of enactment, bill number, public law number, and chapter number, shall be printed as a headnote.

(c) *Cross reference.* For saving provisions, effective date provisions, and other related provisions, see chapter 80 (sec. 7801 and following) of the Internal Revenue Code of 1954.

(d) *Enactment of Internal Revenue Title into law.* The Internal Revenue Title referred to in subsection (a)(1) is as follows:

* * * * *

In general, the provisions of the Internal Revenue Code of 1954 are applicable with respect to taxable years beginning after December 31, 1953, and ending after August 16, 1954. Certain provisions of that Code are deemed to be included in the Internal Revenue Code of 1939. See section 7851.

(b) *Scope of regulations.* The regulations in this part deal with (1) the income taxes imposed under subtitle A of the Internal Revenue Code of 1954, and (2) certain administrative provisions contained in subtitle F of such Code relating to such taxes. In general, the applicability of such regulations is commensurate with the applicability of the respective provisions of the Internal Revenue Code of 1954 except that with respect to the provisions of the Internal Revenue Code of 1954 which are deemed to be included in the Internal Revenue Code of 1939, the regulations relating to such provisions are applicable to certain fiscal years and short taxable years which are subject to the Internal Revenue Code of 1939. Those provisions of the regulations which are applicable to taxable years subject to the Internal Revenue Code of 1939 and the specific taxable years to which such provisions are so applicable are identified in each instance. The regulations in 26 CFR (1939) part 39 (Regulations 118) are continued in effect until superseded by the regulations in this part. See Treasury Decision 6091, approved August 16, 1954 (19 FR 5167, C.B. 1954–2, 47).

NORMAL TAXES AND SURTAXES

DETERMINATION OF TAX LIABILITY

TAX ON INDIVIDUALS

§ 1.1–1 Income tax on individuals.

(a) *General rule.* (1) Section 1 of the Code imposes an income tax on the income of every individual who is a citizen or resident of the United States and, to the extent provided by section 871(b) or 877(b), on the income of a nonresident alien individual. For optional tax in the case of taxpayers with adjusted gross income of less than $10,000 (less than $5,000 for taxable years beginning before January 1, 1970) see section 3. The tax imposed is upon taxable income (determined by subtracting the allowable deductions from gross income). The tax is determined in accordance with the table contained in section 1. See subparagraph (2) of this paragraph for reference guides to the appropriate table for taxable years beginning on or after January 1, 1964, and before January 1, 1965, taxable years beginning after December 31, 1964, and before January 1, 1971, and taxable years beginning after December 31, 1970. In certain cases credits are allowed against the amount of the tax. See part IV (section 31 and following), subchapter A, chapter 1 of the Code. In general, the tax is payable upon the basis of returns rendered by persons liable therefor (subchapter A (sections 6001 and following), chapter 61 of the Code) or at the source of the income by withholding. For the computation of tax in the case of a joint return of a husband and wife, or a return of a surviving spouse, for taxable years beginning before January 1, 1971, see section 2. The computation of tax in such a case for taxable years beginning after December 31, 1970, is determined in accordance with the table contained in section 1(a) as amended by the Tax Reform Act of 1969. For other rates of tax on individuals, see section 5(a). For the imposition of an additional tax for the calendar years 1968, 1969, and 1970, see section 51(a).

(2)(i) For taxable years beginning on or after January 1, 1964, the tax imposed upon a single individual, a head of a household, a married individual filing a separate return, and estates and trusts is the tax imposed by section 1 determined in accordance with the appropriate table contained in the following subsection of section 1:

	Taxable years beginning in 1964	Taxable years beginning after 1964 but before 1971	Taxable years beginning after Dec. 31, 1970 (references in this column are to the Code as amended by the Tax Reform Act of 1969)
Single individual	Sec. 1(a)(1)	Sec. 1(a)(2)	Sec. 1(c).
Head of a household	Sec. 1(b)(1)	Sec. 1(b)(2)	Sec. 1(b).
Married individual filing a separate return.	Sec. 1(a)(1)	Sec. 1(a)(2)	Sec. 1(d).
Estates and trusts	Sec. 1(a)(1)	Sec. 1(a)(2)	Sec. 1(d).

(ii) For taxable years beginning after December 31, 1970, the tax imposed by section 1(d), as amended by the Tax Reform Act of 1969, shall apply to the income effectively connected with the conduct of a trade or business in the United States by a married alien individual who is a nonresident of the United States for all or part of the taxable year or by a foreign estate or trust. For such years the tax imposed by section 1(c), as amended by such Act, shall apply to the income effectively connected with the conduct of a trade or business in the United States by an unmarried alien individual (other than a surviving spouse) who is a nonresident of the United States for all or part of the taxable year. See paragraph (b)(2) of §1.871–8.

(3) The income tax imposed by section 1 upon any amount of taxable income is computed by adding to the income tax for the bracket in which that amount falls in the appropriate table in section 1 the income tax upon the excess of that amount over the bottom of the bracket at the rate indicated in such table.

(4) The provisions of section 1 of the Code, as amended by the Tax Reform Act of 1969, and of this paragraph may be illustrated by the following examples:

Example 1. A, an unmarried individual, had taxable income for the calendar year 1964 of $15,750. Accordingly, the tax upon such taxable income would be $4,507.50, computed as follows from the table in section 1(a)(1):

Tax on $14,000 (from table)	$3,790.00
Tax on $1,750 (at 41 percent as determined from the table)	717.50
Total tax on $15,750	4,507.50

Example 2. Assume the same facts as in example (1), except the figures are for the calendar year 1965. The tax upon such taxable income would be $4,232.50, computed as follows from the table in section 1(a)(2):

Tax on $14,000 (from table)	$3,550.00
Tax on $1,750 (at 39 percent as determined from the table)	682.50
Total tax on $15,750	4,232.50

Example 3. Assume the same facts as in example (1), except the figures are for the calendar year 1971. The tax upon such taxable income would be $3,752.50, computed as follows from the table in section 1(c), as amended:

Tax on $14,000 (from table)	$3,210.00
Tax on $1,750 (at 31 percent as determined from the table)	542.50
Total tax on $15,750	3,752.50

(b) *Citizens or residents of the United States liable to tax.* In general, all citizens of the United States, wherever resident, and all resident alien individuals are liable to the income taxes imposed by the Code whether the income is received from sources within or without the United States. Pursuant to section 876, a nonresident alien individual who is a bona fide resident of a section 931 possession (as defined in §1.931–1(c)(1) of this chapter) or Puerto Rico during the entire taxable year is, except as provided in section 931 or 933 with respect to income from sources within such possessions, subject to taxation in the same manner as a resident alien individual. As to tax on nonresident alien individuals, see sections 871 and 877.

(c) *Who is a citizen.* Every person born or naturalized in the United States and subject to its jurisdiction is a citizen.

For other rules governing the acquisition of citizenship, see chapters 1 and 2 of title III of the Immigration and Nationality Act (8 U.S.C. 1401–1459). For rules governing loss of citizenship, see sections 349 to 357, inclusive, of such Act (8 U.S.C. 1481–1489), Schneider v. Rusk, (1964) 377 U.S. 163, and Rev. Rul. 70–506, C.B. 1970–2, 1. For rules pertaining to persons who are nationals but not citizens at birth, e.g., a person born in American Samoa, see section 308 of such Act (8 U.S.C. 1408). For special rules applicable to certain expatriates who have lost citizenship with a principal purpose of avoiding certain taxes, see section 877. A foreigner who has filed his declaration of intention of becoming a citizen but who has not yet been admitted to citizenship by a final order of a naturalization court is an alien.

(d) *Effective/applicability date.* The second sentence of paragraph (b) of this section applies to taxable years ending after April 9, 2008.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 7332, 39 FR 44216, Dec. 23, 1974; T.D. 9391, 73 FR 19358, Apr. 9, 2008]

§ 1.1–2 Limitation on tax.

(a) *Taxable years ending before January 1, 1971.* For taxable years ending before January 1, 1971, the tax imposed by section 1 (whether by subsection (a) or subsection (b) thereof) shall not exceed 87 percent of the taxable income for the taxable year. For purposes of determining this limitation the tax under section 1 (a) or (b) and the tax at the 87-percent rate shall each be computed before the allowance of any credits against the tax. Where the alternative tax on capital gains is imposed under section 1201(b), the 87-percent limitation shall apply only to the partial tax computed on the taxable income reduced by 50 percent of the excess of net long-term capital gains over net short-term capital losses. Where, for purposes of computations under the income averaging provisions, section 1201(b) is treated as imposing the alternative tax on capital gains computed under section 1304(e)(2), the 87-percent limitation shall apply only to the tax equal to the tax imposed by section 1, reduced by the amount of the tax imposed by section 1 which is attributable to capital gain net income for the computation year.

(b) *Taxable years beginning after December 31, 1970.* If, for any taxable year beginning after December 31, 1970, an individual has earned taxable income which exceeds his taxable income as defined by section 1348, the tax imposed by section 1, as amended by the Tax Reform Act of 1969, shall not exceed the sum computed under the provisions of section 1348. For imposition of minimum tax for tax preferences see sections 56 through 58.

[T.D. 7117, 36 FR 9397, May 25, 1971]

§ 1.1–3 Change in rates applicable to taxable year.

For computation of the tax for a taxable year during which a change in the tax rates occurs, see section 21 and the regulations thereunder.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960. Redesignated by T.D. 7117, 36 FR 9397, May 25, 1971]

§ 1.1(h)–1 Capital gains look-through rule for sales or exchanges of interests in a partnership, S corporation, or trust.

(a) *In general.* When an interest in a partnership held for more than one year is sold or exchanged, the transferor may recognize ordinary income (e.g., under section 751(a)), collectibles gain, section 1250 capital gain, and residual long-term capital gain or loss. When stock in an S corporation held for more than one year is sold or exchanged, the transferor may recognize ordinary income (e.g., under sections 304, 306, 341, 1254), collectibles gain, and residual long-term capital gain or loss. When an interest in a trust held for more than one year is sold or exchanged, a transferor who is not treated as the owner of the portion of the trust attributable to the interest sold or exchanged (sections 673 through 679) (a non-grantor transferor) may recognize collectibles gain and residual long-term capital gain or loss.

(b) *Look-through capital gain*—(1) *In general.* Look-through capital gain is the share of collectibles gain allocable to an interest in a partnership, S corporation, or trust, plus the share of section 1250 capital gain allocable to an interest in a partnership, determined under paragraphs (b)(2) and (3) of this section.

(2) *Collectibles gain*—(i) *Definition*. For purposes of this section, *collectibles gain* shall be treated as gain from the sale or exchange of a collectible (as defined in section 408(m) without regard to section 408(m)(3)) that is a capital asset held for more than 1 year.

(ii) *Share of collectibles gain allocable to an interest in a partnership, S corporation, or a trust*. When an interest in a partnership, S corporation, or trust held for more than one year is sold or exchanged in a transaction in which all realized gain is recognized, the transferor shall recognize as collectibles gain the amount of net gain (but not net loss) that would be allocated to that partner (taking into account any remedial allocation under §1.704–3(d)), shareholder, or beneficiary (to the extent attributable to the portion of the partnership interest, S corporation stock, or trust interest transferred that was held for more than one year) if the partnership, S corporation, or trust transferred all of its collectibles for cash equal to the fair market value of the assets in a fully taxable transaction immediately before the transfer of the interest in the partnership, S corporation, or trust. If less than all of the realized gain is recognized upon the sale or exchange of an interest in a partnership, S corporation, or trust, the same methodology shall apply to determine the collectibles gain recognized by the transferor, except that the partnership, S corporation, or trust shall be treated as transferring only a proportionate amount of each of its collectibles determined as a fraction that is the amount of gain recognized in the sale or exchange over the amount of gain realized in the sale or exchange. With respect to the transfer of an interest in a trust, this paragraph (b)(2) applies only to transfers by nongrantor transferors (as defined in paragraph (a) of this section). This paragraph (b)(2) does not apply to a transaction that is treated, for Federal income tax purposes, as a redemption of an interest in a partnership, S corporation, or trust.

(3) *Section 1250 capital gain*—(i) *Definition*. For purposes of this section, *section 1250 capital gain* means the capital gain (not otherwise treated as ordinary income) that would be treated as ordinary income if section 1250(b)(1) included all depreciation and the applicable percentage under section 1250(a) were 100 percent.

(ii) *Share of section 1250 capital gain allocable to interest in partnership*. When an interest in a partnership held for more than one year is sold or exchanged in a transaction in which all realized gain is recognized, there shall be taken into account under section 1(h)(7)(A)(i) in determining the partner's unrecaptured section 1250 gain the amount of section 1250 capital gain that would be allocated (taking into account any remedial allocation under §1.704–3(d)) to that partner (to the extent attributable to the portion of the partnership interest transferred that was held for more than one year) if the partnership transferred all of its section 1250 property in a fully taxable transaction for cash equal to the fair market value of the assets immediately before the transfer of the interest in the partnership. If less than all of the realized gain is recognized upon the sale or exchange of an interest in a partnership, the same methodology shall apply to determine the section 1250 capital gain recognized by the transferor, except that the partnership shall be treated as transferring only a proportionate amount of each section 1250 property determined as a fraction that is the amount of gain recognized in the sale or exchange over the amount of gain realized in the sale or exchange. This paragraph (b)(3) does not apply to a transaction that is treated, for Federal income tax purposes, as a redemption of a partnership interest.

(iii) *Limitation with respect to net section 1231 gain*. In determining a transferor partner's net section 1231 gain (as defined in section 1231(c)(3)) for purposes of section 1(h)(7)(B), the transferor partner's allocable share of section 1250 capital gain in partnership property shall not be treated as section 1231 gain, regardless of whether the partnership property is used in the trade or business (as defined in section 1231(b)).

(c) *Residual long-term capital gain or loss*. The amount of residual long-term capital gain or loss recognized by a partner, shareholder of an S corporation, or beneficiary of a trust on account of the sale or exchange of an interest in a partnership, S corporation, or trust shall equal the amount of long-term capital gain or loss that the partner would recognize under section 741, that the shareholder would recognize upon the sale or exchange of stock of an S corporation, or that the beneficiary would recognize upon the sale or exchange of an interest in a trust (pre-look-through long-term capital gain or loss) minus the amount of look-through capital gain determined under paragraph (b) of this section.

(d) *Special rule for tiered entities.* In determining whether a partnership, S corporation, or trust has gain from collectibles, such partnership, S corporation, or trust shall be treated as owning its proportionate share of the collectibles of any partnership, S corporation, or trust in which it owns an interest either directly or indirectly through a chain of such entities. In determining whether a partnership has section 1250 capital gain, such partnership shall be treated as owning its proportionate share of the section 1250 property of any partnership in which it owns an interest, either directly or indirectly through a chain of partnerships.

(e) *Notification requirements.* Reporting rules similar to those that apply to the partners and the partnership under section 751(a) shall apply in the case of sales or exchanges of interests in a partnership, S corporation, or trust that cause holders of such interests to recognize collectibles gain and in the case of sales or exchanges of interests in a partnership that cause holders of such interests to recognize section 1250 capital gain. See §1.751–1(a)(3).

(f) *Examples.* The following examples illustrate the requirements of this section:

Example 1. Collectibles gain. (i) *A* and *B* are equal partners in a personal service partnership (*PRS*). *B* transfers *B*'s interest in *PRS* to *T* for $15,000 when *PRS*'s balance sheet (reflecting a cash receipts and disbursements method of accounting) is as follows:

	ASSETS	
	Adjusted basis	Market value
Cash	$3,000	$3,000
Loans Owed to Partnership	10,000	10,000
Collectibles	1,000	3,000
Other Capital Assets	6,000	2,000
Capital Assets	7,000	5,000
Unrealized Receivables	0	14,000
Total	20,000	32,000

	LIABILITIES AND CAPITAL	
	Adjusted basis	Market value
Liabilities	2,000	2,000
Capital:		
A	9,000	15,000
B	9,000	15,000
Total	20,000	32,000

(ii) At the time of the transfer, *B* has held the interest in *PRS* for more than one year, and *B*'s basis for the partnership interest is $10,000 ($9,000 plus $1,000, *B*'s share of partnership liabilities). None of the property owned by *PRS* is section 704(c) property. The total amount realized by *B* is $16,000, consisting of the cash received, $15,000, plus $1,000, *B*'s share of the partnership liabilities assumed by *T*. See section 752. *B*'s undivided one-half interest in *PRS* includes a one-half interest in the partnership's unrealized receivables and a one-half interest in the partnership's collectibles.

(iii) If *PRS* were to sell all of its section 751 property in a fully taxable transaction for cash equal to the fair market value of the assets immediately prior to the transfer of *B's* partnership interest to *T*, *B* would be allocated $7,000 of ordinary income from the sale of *PRS*'s unrealized receivables. Therefore, *B* will recognize $7,000 of ordinary income with respect to the unrealized receivables. The difference between the amount of capital gain or loss that the partner would realize in the absence of section 751 ($6,000) and the amount of ordinary income or loss determined under §1.751–1(a)(2) ($7,000) is the partner's capital gain or loss on the sale of the partnership interest under section 741. In this case, the transferor has a $1,000 pre-look-through long-term capital loss.

(iv) If *PRS* were to sell all of its collectibles in a fully taxable transaction for cash equal to the fair market value of the assets immediately prior to the transfer of *B's* partnership interest to *T*, *B* would be allocated $1,000 of gain from the sale of the collectibles. Therefore, *B* will recognize $1,000 of collectibles gain on account of the collectibles held by *PRS*.

(v) The difference between the transferor's pre-look-through long-term capital gain or loss (−$1,000) and the look-through capital gain determined under this section ($1,000) is the transferor's residual long-term capital gain or loss on the sale of the partnership interest. Under these facts, *B* will recognize a $2,000 residual long-term capital loss on account of the sale or exchange of the interest in *PRS*.

Example 2. Special allocations. Assume the same facts as in *Example 1*, except that under the partnership agreement, all gain from the sale of the collectibles is specially allocated to *B*, and *B* transfers *B*'s interest to *T* for $16,000. All items of income, gain, loss, or deduction of *PRS*, other than the gain from the collectibles, are divided equally between *A* and *B*. Under these facts, *B*'s amount realized is $17,000, consisting of the cash received, $16,000, plus $1,000, *B's* share of the partnership liabilities assumed by *T*. See section 752. *B* will recognize $7,000 of ordinary income with respect to the unrealized receivables (determined under §1.751–1(a)(2)). Accordingly, *B*'s pre-look-through long-term capital gain would be $0. If *PRS* were to sell all of its collectibles in a fully taxable transaction for cash equal to the fair market value of the assets immediately prior to the transfer of *B's* partnership interest to *T*, *B* would be allocated $2,000 of gain from the sale of the collectibles. Therefore, *B* will recognize $2,000 of collectibles gain on account of the collectibles held by *PRS*. *B* will recognize a $2,000 residual long-term capital loss on account of the sale of *B's* interest in *PRS*.

Example 3. Net collectibles loss ignored. Assume the same facts as in *Example 1*, except that the collectibles held by *PRS* have an adjusted basis of $3,000 and a fair market value of $1,000, and the other capital assets have an adjusted basis of $4,000 and a fair market value of $4,000. (The total adjusted basis and fair market value of the partnership's capital assets are the same as in *Example 1*.) If *PRS* were to sell all of its collectibles in a fully taxable transaction for cash equal to the fair market value of the assets immediately prior to the transfer of *B*'s partnership interest to *T*, *B* would be allocated $1,000 of loss from the sale of the collectibles. Because none of the gain from the sale of the interest in *PRS* is attributable to unrealized appreciation in the value of collectibles held by *PRS*, the net loss in collectibles held by *PRS* is not recognized at the time *B* transfers the interest in *PRS*. *B* will recognize $7,000 of ordinary income (determined under §1.751–1(a)(2)) and a $1,000 long-term capital loss on account of the sale of B's interest in *PRS*.

Example 4. Collectibles gain in an S corporation. (i) A corporation (*X*) has always been an S corporation and is owned by individuals *A*, *B*, and *C*. In 1996, *X* invested in antiques. Subsequent to their purchase, the antiques appreciated in value by $300. *A* owns one-third of the shares of *X* stock and has held that stock for more than one year. *A*'s adjusted basis in the *X* stock is $100. If *A* were to sell all of *A*'s *X* stock to *T* for $150, *A* would realize $50 of pre-look-through long-term capital gain.

(ii) If *X* were to sell its antiques in a fully taxable transaction for cash equal to the fair market value of the assets immediately before the transfer to *T*, *A* would be allocated $100 of gain on account of the sale. Therefore, *A* will recognize $100 of collectibles gain (look-through capital gain) on account of the collectibles held by *X*.

(iii) The difference between the transferor's pre-look-through long-term capital gain or loss ($50) and the look-through capital gain determined under this section ($100) is the transferor's residual long-term capital gain or loss on the sale of the S corporation stock. Under these facts, *A* will recognize $100 of collectibles gain and a $50 residual long-term capital loss on account of the sale of *A*'s interest in *X*.

Example 5. Sale or exchange of partnership interest where part of the interest has a short-term holding period. (i) *A*, *B*, and *C* form an equal partnership (*PRS*). In connection with the formation, *A* contributes $5,000 in cash and a capital asset with a fair market value of $5,000 and a basis of $2,000; *B* contributes $7,000 in cash and a collectible with a fair market value of $3,000 and a basis of $3,000; and *C* contributes $10,000 in cash. At the time of the contribution, *A* had held the contributed property for two years. Six months later, when *A*'s basis in *PRS* is $7,000, *A* transfers *A*'s interest in *PRS* to *T* for $14,000 at a time when *PRS*'s balance sheet (reflecting a cash receipts and disbursements method of accounting) is as follows:

	ASSETS	
	Adjusted basis	Market value
Cash	$22,000	$22,000
Unrealized Receivables	0	6,000
Capital Asset	2,000	5,000
Collectible	3,000	9,000
Capital Assets	5,000	14,000
Total	27,000	42,000

(ii) Although at the time of the transfer *A* has not held *A*'s interest in *PRS* for more than one year, 50 percent of the fair market value of *A*'s interest in *PRS* was received in exchange for a capital asset with a long-term holding period. Therefore, 50 percent of *A*'s interest in *PRS* has a long-term holding period. See §1.1223–3(b)(1).

(iii) If *PRS* were to sell all of its section 751 property in a fully taxable transaction immediately before *A*'s transfer of the partnership interest, *A* would be allocated $2,000 of ordinary income. Accordingly, *A* will recognize $2,000 ordinary income and $5,000 ($7,000–

$2,000) of capital gain on account of the transfer to *T* of *A*'s interest in *PRS*. Fifty percent ($2,500) of that gain is long-term capital gain and 50 percent ($2,500) is short-term capital gain. See §1.1223–3(c)(1).

(iv) If the collectible were sold or exchanged in a fully taxable transaction immediately before *A*'s transfer of the partnership interest, *A* would be allocated $2,000 of gain attributable to the collectible. The gain attributable to the collectible that is allocable to the portion of the transferred interest in *PRS* with a long-term holding period is $1,000 (50 percent of $2,000). Accordingly, *A* will recognize $1,000 of collectibles gain on account of the transfer of *A*'s interest in *PRS*.

(v) The difference between the amount of pre-look-through long-term capital gain or loss ($2,500) and the look-through capital gain ($1,000) is the amount of residual long-term capital gain or loss that *A* will recognize on account of the transfer of *A*'s interest in *PRS*. Under these facts, *A* will recognize a residual long-term capital gain of $1,500 and a short-term capital gain of $2,500.

(g) *Effective date.* This section applies to transfers of interests in partnerships, S corporations, and trusts that occur on or after September 21, 2000.

[T.D. 8902, 65 FR 57096, Sept. 21, 2000]

§ 1.1(i)–1T Questions and answers relating to the tax on unearned income certain minor children (Temporary).

In General

Q–1. To whom does section 1(i) apply?

A–1. Section 1(i) applies to any child who is under 14 years of age at the close of the taxable year, who has at least one living parent at the close of the taxable year, and who recognizes over $1,000 of unearned income during the taxable year.

Q–2. What is the effective date of section 1(i)?

A–2. Section 1(i) applies to taxable years of the child beginning after December 31, 1986.

Computation of Tax

Q–3. What is the amount of tax imposed by section 1 on a child to whom section 1(i) applies?

A–3. In the case of a child to whom section 1(i) applies, the amount of tax imposed by section 1 equals the greater of (A) the tax imposed by section 1 without regard to section 1(i) or (B) the sum of the tax that would be imposed by section 1 if the child's taxable income was reduced by the child's net unearned income, plus the child's share of the allocable parental tax.

Q–4. What is the allocable parental tax?

A–4. The allocable parental tax is the excess of (A) the tax that would be imposed by section 1 on the sum of the parent's taxable income plus the net unearned income of all children of such parent to whom section 1(i) applies, over (B) the tax imposed by section 1 on the parent's taxable income. Thus, the allocable parental tax is not computed with reference to unearned income of a child over 14 or a child under 14 with less than $1,000 of unearned income. *See* A–10 through A–13 for rules regarding the determination of the parent(s) whose taxable income is taken into account under section 1(i). *See* A–14 for rules regarding the determination of children of the parent whose net unearned income is taken into account under section 1(i).

Q–5. What is the child's share of the allocable parental tax?

A–5. The child's share of the allocable parental tax is an amount that bears the same ratio to the total allocable parental tax as the child's net unearned income bears to the total net unearned income of all children of such parent to whom section 1(i) applies. See A–14.

Example 1. During 1988, D, and a 12 year old, receives $5,000 of unearned income and no earned income. D has no itemized deductions and is not eligible for a personal exemption. D's parents have two other children, E, a 15 year old, and F, a 10 year old. E has $10,000 of unearned income and F has $100 of unearned income. D's parents file a joint return for 1988 and report taxable income of $70,000. Neither D's nor his parent's taxable income is attributable to net capital gain. D's tax liability for 1988, determined without regard to section 1(i), is $675 on $4,500 of taxable income ($5,000 less $500 allowable standard deduction). In applying section 1(i), D's tax would be equal to the sum of (A) the tax that would be imposed on D's taxable income if it were reduced by any net unearned income, plus (B) D's share of the allocable parental tax. Only D's unearned income is taken into account in determining the allocable parental tax because E is over 14 and F has less than $1,000 of unearned income. *See* A–4. D's net unearned income is $4,000 ($4,500 taxable unearned income less $500). The tax imposed on D's taxable income as reduced by D's net unearned income is $75 ($500 × 15%). The allocable parental tax is $1,225, the excess of $16,957.50 (the tax on $74,000, the parent's taxable income plus D's net unearned income) over $15,732.50 (the tax on $70,000, the parent's taxable income). *See* A–4. Thus, D's tax under section 1(i)(1)(B) is $1,300 ($1,225 + $75). Since this amount is greater than the amount of D's tax liability as determined without regard to section 1(i), the amount of tax imposed on D for 1988 is $1,300. *See A–3.*

Example 2. H and W have 3 children, A, B, and C, who are all under 14 years of age. For the taxable year 1988, H and W file a joint return and report taxable income of $129,750. The tax imposed by section 1 on H and W is $35,355. A has $5,000 of net unearned income and B and C each have $2,500 of net unearned income during 1988. The allocable parental tax imposed on A, B, and C's combined net unearned income of $10,000 is $3,300. This tax is the excess of $38,655, which is the tax imposed by section 1 on $139,750 ($129,750 + 10,000), over $35,355 (the tax imposed by section 1 on H and W's taxable income of $129,750). *See* A–4. Each child's share of the allocable parental tax is an amount that bears the same ratio to the total allocable parental tax as the child's net unearned income bears to the total net unearned income of A, B, and C. Thus, A's share of the allocable parental tax is $1,650 (5,000 ÷ 10,000 × 3,300) and B and C's share of the tax is $825 (2,500 ÷ 10,000 × 3,300) each. *See* A–5.

DEFINITION OF NET UNEARNED INCOME

Q–6. What is net unearned income?

A–6. Net unearned income is the excess of the portion of adjusted gross income for the taxable year that is not "earned income" as defined in section 911(d)(2) (income that is not attributable to wages, salaries, or other amounts received as compensation for personal services), over the sum of the standard deduction amount provided for under section 63 (c)(5)(A) ($500 for 1987 and 1988; adjusted for inflation thereafter), plus the greater of (A) $500 (adjusted for inflation after 1988) or (B) the amount of allowable itemized deductions that are directly connected with the production of unearned income. A child's net unearned income for any taxable year shall not exceed the child's taxable income for such year.

Example 3. A is a child who is under 14 years of age at the end of the taxable year 1987. Both of A's parents are alive at this time. During 1987, A receives $3,000 of interest from a bank savings account and earns $1,000 from a paper route and performing odd jobs. A has no itemized deductions for 1987. A's standard deduction is $1,000, which is an amount equal to A's earned income for 1987. Of this amount, $500 is applied against A's unearned income and the remaining $500 is applied against A's earned income. Thus, A's $500 of taxable earned income ($1,000 less the remaining $500 of the standard deduction) is taxed without regard to section 1 (i); A has $2,500 of taxable unearned income ($3,000 gross unearned income less $500 of the standard deduction) of which $500 is taxed without regard to section 1(i). The remaining $2,000 of taxable unearned income is A's net unearned income and is taxed under section 1(i).

Example 4. B is a child who is subject to tax under section 1(i). B has $400 of earned income and $2,000 of unearned income. B has itemized deductions of $800 (net of the 2 percent of adjusted gross income (AGI) floor on miscellaneous itemized deductions under section 67) of which $200 are directly connected with the production of unearned income. The amount of itemized deductions that B may apply against unearned income is equal to the greater of $500 or the deductions directly connected with the production of unearned income. *See* A–6. Thus, $500 of B's itemized deductions are applied against the $2,000 of unearned income and the remaining $300 of deductions are applied against earned income. As a result, B has taxable earned income of $100 and taxable unearned income of $1,500. Of these amounts, all of the earned income and $500 of the unearned income are taxed without regard to section 1(i). The remaining $1,000 of unearned income is net unearned income and is taxed under section 1(i).

UNEARNED INCOME SUBJECT TO TAX UNDER SECTION 1(i)

Q–7. Will a child be subject to tax under section 1(i) on net unearned income (as defined in section 1(i) (4) and A–6 of this section) that is attributable to property transferred to the child prior to 1987?

A–7. Yes. The tax imposed by section 1(i) on a child's net unearned income applies to any net unearned income of the child for taxable years beginning after December 31, 1986, regardless of when the underlying assets were transferred to the child.

Q–8. Will a child be subject to tax under section 1(i) on net unearned income that is attributable to gifts from persons other than the child's parents or attributable to assets resulting from the child's earned income?

A–8. Yes. The tax imposed by section 1(i) applies to all net unearned income of the child, regardless of the source of the assets that produced such income. Thus, the rules of section 1(i) apply to income attributable to gifts not only from the parents but also from any other source, such as the child's grandparents. Section 1(i) also applies to unearned income derived with respect to assets resulting from earned income of the child, such as interest earned on bank deposits.

Example 5. A is a child who is under 14 years of age at the end of the taxable year beginning on January 1, 1987. Both of A's parents are alive at the end of the taxable year. During 1987, A receives $2,000 in interest from his bank account and $1,500 from a paper route. Some of the interest earned by A from the bank account is attributable to A's paper route earnings that were deposited in the account. The balance of the account is attributable to cash gifts from A's parents and grandparents and interest earned prior to 1987. Some cash gifts were received by A prior to 1987. A has no itemized deductions and is eligible to be claimed as a dependent on his parent's return. Therefore, for the taxable year 1987, A's standard deduction is $1,500, the amount of A's earned income. Of this standard deduction amount, $500 is allocated against unearned income and $1,000 is allocated against earned income. A's taxable unearned income is $1,500 of which $500 is taxed without regard to section 1(i). The remaining taxable unearned income of $1,000 is net unearned income and is taxed under section 1(i). The fact that some of A's unearned income is attributable to interest on principal created by earned income and gifts from persons other than A's parents or that some of the unearned income is attributable to property transferred to A prior to 1987, will not affect the tax treatment of this income under section 1(i). *See* A–8.

Q–9. For purposes of section 1(i), does income which is not earned income (as defined in section 911(d)(2)) include social security benefits or pension benefits that are paid to the child?

A–9. Yes. For purposes of section 1(i), earned income (as defined in section 911(d)(2)) does not include any social security or pension benefits paid to the child. Thus, such amounts are included in unearned income to the extent they are includible in the child's gross income.

DETERMINATION OF THE PARENT'S TAXABLE INCOME

Q–10. If a child's parents file a joint return, what is the taxable income that must be taken into account by the child in determining tax liability under section 1(i)?

A–10. In the case of parents who file a joint return, the parental taxable income to be taken into account in determining the tax liability of a child is the total taxable income shown on the joint return.

Q–11. If a child's parents are married and file separate tax returns, which parent's taxable income must be taken into account by the child in determining tax liability under section 1(i)?

A–11. For purposes of determining the tax liability of a child under section 1(i), where such child's parents are married and file separate tax returns, the parent whose taxable income is the greater of the two for the taxable year shall be taken into account.

Q–12. If the parents of a child are divorced, legally separated, or treated as not married under section 7703(b), which parent's taxable income is taken into account in computing the child's tax liability?

A–12. If the child's parents are divorced, legally separated, or treated as not married under section 7703(b), the taxable income of the custodial parent (within the meaning of section 152(e)) of the child is taken into account under section 1(i) in determining the child's tax liability.

Q–13. If a parent whose taxable income must be taken into account in determining a child's tax liability under section 1(i) files a joint return with a spouse who is not a parent of the child, what taxable income must the child take into account?

A–13. The amount of a parent's taxable income that a child must take into account for purposes of section 1(i) where the parent files a joint return with a spouse who is not a parent of the child is the total taxable income shown on such joint return.

CHILDREN OF THE PARENT

Q–14. In determining a child's share of the allocable parental tax, is the net unearned income of legally adopted children, children related to such child by half-blood, or children from a prior marriage of the spouse of such child's parent taken into account in addition to the natural children of such child's parent?

A–14. Yes. In determining a child's share of the allocable parental tax, the net unearned income of all children subject to tax under section 1(i) and who use the same parent's taxable income as such child to determine their tax liability under section 1(i) must be taken into account. Such children are taken into account regardless of whether they are adopted by the parent, related to such child by half-blood, or are children from a prior marriage of the spouse of such child's parent.

RULES REGARDING INCOME FROM A TRUST OR SIMILAR INSTRUMENT

Q–15. Will the unearned income of a child who is subject to section 1(i) that is attributable to gifts given to the child under the Uniform Gift to Minors Act (UGMA) be subject to tax under section 1(i)?

A–15. Yes. A gift under the UGMA vests legal title to the property in the child although an adult custodian is given certain rights to deal with the property until the child attains majority. Any unearned income attributable to such a gift is the child's unearned income and is subject to tax under section 1(i), whether distributed to the child or not.

Q–16. Will a child who is a beneficiary of a trust be required to take into account the income of a trust in determining the child's tax liability under section 1(i)?

A–16. The income of a trust must be taken into account for purposes of determining the tax liability of a beneficiary who is subject to section 1(i) only to the extent it is included in the child's gross income for the taxable year under sections 652(a) or 662(a). Thus, income from a trust for the fiscal taxable year of a trust ending during 1987, that is included in the gross income of a child who is subject to section 1(i) and who has a calendar taxable year, will be subject to tax under section 1(i) for the child's 1987 taxable year.

SUBSEQUENT ADJUSTMENTS

Q–17. What effect will a subsequent adjustment to a parent's taxable income have on the child's tax liability if such parent's taxable income was used to determine the child's tax liability under section 1(i) for the same taxable year?

A–17. If the parent's taxable income is adjusted and if, for the same taxable year as the adjustment, the child paid tax determined under section 1(i) with reference to that parent's taxable income, then the child's tax liability under section 1(i) must be recomputed using the parent's taxable income as adjusted.

Q–18. In the case where more than one child who is subject to section 1(i) uses the same parent's taxable income to determine their allocable parental tax, what effect will a subsequent adjustment to the net unearned income of one child have on the other child's share of the allocable parental tax?

A–18. If, for the same taxable year, more than one child uses the same parent's taxable income to determine their share of the allocable parental tax and a subsequent adjustment is made to one or more of such children's net unearned income, each child's share of the allocable parental tax must be recomputed using the combined net unearned income of all such children as adjusted.

Q–19. If a recomputation of a child's tax under section 1(i), as a result of an adjustment to the taxable income of the child's parents or another child's net unearned income, results in additional tax being imposed by section 1(i) on the child, is the child subject to interest and penalties on such additional tax?

A–19. Any additional tax resulting from an adjustment to the taxable income of the child's parents or the net unearned income of another child shall be treated as an underpayment of tax and interest shall be imposed on such underpayment as provided in section 6601. However, the child shall not be liable for any penalties on the underpayment resulting from additional tax being imposed under section 1(i) due to such an adjustment.

Example 6. D and M are the parents of C, a child under the age of 14. D and M file a joint return for 1988 and report taxable income of $69,900. C has unearned income of $3,000 and no itemized deductions for 1988. C properly reports a total tax liability of $635 for 1988. This amount is the sum of the allocable parental tax of $560 on C's net unearned income of $2,000 (the excess of $3,000 over the sum of $500 standard deduction and the first $500 of taxable unearned income) plus $75 (the tax imposed on C's first $500 of taxable unearned income). *See* A–3. One year later, D and M's 1988 tax return is adjusted on audit by adding an additional $1,000 of taxable income. No adjustment is made to the amount reported as C's net unearned income for 1988. However, the adjustment to D and M's taxable income causes C's tax liability under section 1(i) for 1988 to be increased by $50 as a result of the phase-out of the 15 percent rate bracket. *See* A–20. In addition to this further tax liability, C will be liable for interest on the $50. However, C will not have to pay any penalty on the delinquent amount.

MISCELLANEOUS RULES

Q–20. Does the phase-out of the parent's 15 percent rate bracket and personal exemptions under section 1(g), if applicable, have any effect on the calculation of the allocable parental tax imposed on a child's net unearned income under section 1(i)?

A–20. Yes. Any phase-out of the parent's 15 percent rate bracket or personal exemptions under section 1(g) is given full effect in determining the tax that would be imposed on the sum of the parent's taxable income and the total net unearned income of all children of the parent. Thus, any additional tax on a child's net unearned income resulting from the phase-out of the 15 percent rate bracket and the personal exemptions is reflected in the tax liability of the child.

Q–21. For purposes of calculating a parent's tax liability or the allocable parental tax imposed on a child, are other phase-outs, limitations, or floors on deductions or credits, such as the phase-out of the $25,000 passive loss allowance for rental real estate activities under section 469(i)(3) or the 2 percent of AGI floor on miscellaneous itemized deductions under section 67, affected by the addition of a child's net unearned income to the parent's taxable income?

A–21. No. A child's net unearned income is not taken into account in computing any deduction or credit for purposes of determining the parent's tax liability or the child's allocable parental tax. Thus, for example, although the amounts allowable to the parent as a charitable contribution deduction, medical expense deduction, section 212 deduction, or a miscellaneous itemized deduction are affected by the amount of the parent's adjusted gross income, the amount of these deductions that is allowed does not change as a result of the application of section 1(i) because the amount of the parent's adjusted gross income does not include the child's net unearned income. Similarly, the amount of itemized deductions that is allowed to a child does not change as a result of section 1(i) because section 1(i) only affects the amount of tax liability and not the child's adjusted gross income.

Q–22. If a child is unable to obtain information concerning the tax return of the child's parents directly from such parents, how may the child obtain information from the parent's tax return which is necessary to determine the child's tax liability under section 1(i)?

A–22. Under section 6103(e)(1)(A)(iv), a return of a parent shall, upon written request, be open to inspection or disclosure to a child of that individual (or the child's legal representative) to the extent necessary to comply with section 1(i). Thus, a child may request the Internal Revenue Service to disclose sufficient tax information about the parent to the child so that the child can properly file his or her return.

[T.D. 8158, 52 FR 33579, Sept. 4, 1987; 52 FR 36133, Sept. 25, 1987]

§ 1.2–1 Tax in case of joint return of husband and wife or the return of a surviving spouse.

(a) *Taxable year ending before January 1, 1971.* (1) For taxable years ending before January 1, 1971, in the case of a joint return of husband and wife, or the return of a surviving spouse as defined in section 2(b), the tax imposed by section 1 shall be twice the tax that would be imposed if the taxable income were reduced by one-half. For rules relating to the filing of joint returns of husband and wife, see section 6013 and the regulations thereunder.

(2) The method of computing, under section 2(a), the tax of husband and wife in the case of a joint return, or the tax of a surviving spouse, is as follows:

(i) First, the taxable income is reduced by one-half. Second, the tax is determined as provided by section 1 by using the taxable income so reduced. Third, the tax so determined, which is the tax that would be determined if the taxable income were reduced by one-half, is then multiplied by two to produce the tax imposed in the case of the joint return or the return of a surviving spouse, subject, however, to the allowance of any credits against the tax under the provisions of sections 31 through 38 and the regulations thereunder.

(ii) The limitation under section 1(c) of the tax to an amount not in excess of a specified percent of the taxable income for the taxable year is to be applied before the third step above, that is, the limitation to be applied upon the tax is determined as the applicable specified percent of one-half of the taxable income for the taxable year (such one-half of the taxable income being the actual aggregate taxable income of the spouses, or the total taxable income of the surviving spouse, as the case may be, reduced by one-half). For the percent applicable in determining the limitation of the tax under section 1(c), see §1.1–2(a). After such limitation is applied, then the tax so limited is multiplied by two as provided in section 2(a) (the third step above).

(iii) The following computation illustrates the method of application of section 2(a) in the determination of the tax of a husband and wife filing a joint return for the calendar year 1965. If the combined gross income is $8,200, and the only deductions are the two exemptions of the taxpayers under section 151(b) and the standard deduction under section 141, the tax on the joint return for 1965, without regard to any credits against the tax, is $1,034.20 determined as follows:

1. Gross income	$8,200.00	
2. Less:		
Standard deduction, section 141	$820	
Deduction for personal exemption, section 151	1,200	2,020.00
3. Taxable income	6,180.00	
4. Taxable income reduced by one-half	3,090.00	
5. Tax computed by the tax table provided under section 1(a)(2) ($310 plus 19 percent of excess over $2,000)	517.10	
6. Twice the tax in item 5	1,034.20	

(b) *Taxable years beginning after December 31, 1970.* (1) For taxable years beginning after December 31, 1970, in the case of a joint return of husband and wife, or the return of a surviving spouse as defined in section 2(a) of the Code as amended by the Tax Reform Act of 1969, the tax shall be determined in accordance with the table contained in section 1(a) of the Code as so amended. For rules relating to the filing of joint returns of husband and wife see section 6013 as amended and the regulations thereunder.

(2) The following computation illustrates the method of computing the tax of a husband and wife filing a joint return for calendar year 1971. If the combined gross income is $8,200, and the only deductions are the two exemptions of the taxpayers under section 151(b), as amended, and the standard deduction under section 141, as amended, the tax on the joint return for 1971, without regard to any credits against the tax, is $968.46, determined as follows:

1. Gross income	$8,200.00	
2. Less:		
Standard deduction, section 141	$1,066.00	
Deduction for personal exemption, section 151	1,300.00	2,366.00
3. Taxable income	5,834.00	
4. Tax computed by the tax table provided under section 1(a) ($620 plus 19 percent of excess over $4,000)	968.46	

(3) The limitation under section 1348 with respect to the maximum rate of tax on earned income shall apply to a married individual only if such individual and his spouse file a joint return for the taxable year.

(c) *Death of a spouse.* If a joint return of a husband and wife is filed under the provisions of section 6013 and if the husband and wife have different taxable years solely because of the death of either spouse, the taxable year of the deceased spouse covered by the joint return shall, for the purpose of the computation of the tax in respect of such joint return, be deemed to have ended on the date of the closing of the surviving spouse's taxable year.

(d) *Computation of optional tax.* For computation of optional tax in the case of a joint return or the return of a surviving spouse, see section 3 and the regulations thereunder.

(e) *Change in rates.* For treatment of taxable years during which a change in the tax rates occurs see section 21 and the regulations thereunder.

[T.D. 7117, 36 FR 9398, May 25, 1971]

§ 1.2–2 Definitions and special rules.

(a) *Surviving spouse.* (1) If a taxpayer is eligible to file a joint return under the Internal Revenue Code of 1954 without regard to section 6013(a) (3) thereof for the taxable year in which his spouse dies, his return for each of the next 2 taxable years following the year of the death of the spouse shall be treated as a joint return for all purposes if all three of the following requirements are satisfied:

(i) He has not remarried before the close of the taxable year the return for which is sought to be treated as a joint return, and

(ii) He maintains as his home a household which constitutes for the taxable year the principal place of abode as a member of such household of a person who is (whether by blood or adoption) a son, stepson, daughter, or stepdaughter of the taxpayer, and

(iii) He is entitled for the taxable year to a deduction under section 151 (relating to deductions for dependents) with respect to such son, stepson, daughter, or stepdaughter.

(2) See paragraphs (c)(1) and (d) of this section for rules for the determination of when the taxpayer maintains as his home a household which constitutes for the taxable year the principal place of abode, as a member of such household, of another person.

(3) If the taxpayer does not qualify as a surviving spouse he may nevertheless qualify as a head of a household if he meets the requirements of §1.2–2(b).

(4) The following example illustrates the provisions relating to a surviving spouse:

Example: Assume that the taxpayer meets the requirements of this paragraph for the years 1967 through 1971, and that the taxpayer, whose wife died during 1966 while married to him, remarried in 1968. In 1969, the taxpayer's second wife died while married to him, and he remained single thereafter. For 1967 the taxpayer will qualify as a surviving spouse, provided that neither the taxpayer nor the first wife was a nonresident alien at any time during 1966 and that she (immediately prior to her death) did not have a taxable year different from that of the taxpayer. For 1968 the taxpayer does not qualify as a surviving spouse because he remarried before the close of the taxable year. The taxpayer will qualify as a surviving spouse for 1970 and 1971, provided that neither the taxpayer nor the second wife was a nonresident alien at any time during 1969 and that she (immediately prior to her death) did not have a taxable year different from that of the taxpayer. On the other hand, if the taxpayer, in 1969, was divorced or legally separated from his second wife, the taxpayer will not qualify as a surviving spouse for 1970 or 1971, since he could not have filed a joint return for 1969 (the year in which his second wife died).

(b) *Head of household.* (1) A taxpayer shall be considered the head of a household if, and only if, he is not married at the close of his taxable year, is not a surviving spouse (as defined in paragraph (a) of this section, and (i) maintains as his home a household which constitutes for such taxable year the principal place of abode, as a member of such household, of at least one of the individuals described in subparagraph (3), or (ii) maintains (whether or not as his home) a household which constitutes for such taxable year the principal place of abode of one of the individuals described in subparagraph (4).

(2) Under no circumstances shall the same person be used to qualify more than one taxpayer as the head of a household for the same taxable year.

(3) Any of the following persons may qualify the taxpayer as a head of a household:

(i) A son, stepson, daughter, or stepdaughter of the taxpayer, or a descendant of a son or daughter of the taxpayer. For the purpose of determining whether any of the stated relationships exist, a legally adopted child of a person is considered a child of such person by blood. If any such person is not married at the close of the taxable year of the taxpayer, the taxpayer may qualify as the head of a household by reason of such person even though the taxpayer may not claim a deduction for such person under section 151, for example, because the taxpayer does not furnish more than half of the support of such person. However, if any such person is married at the close of the taxable year of the taxpayer, the taxpayer may qualify as the head of a household by reason of such person only if the taxpayer is entitled to a deduction for such person under section 151 and the regulations thereunder. In applying the preceding sentence there shall be disregarded any such person for whom a deduction is allowed under section 151 only by reason of section 152(c) (relating to persons covered by a multiple support agreement).

(ii) Any other person who is a dependent of the taxpayer, if the taxpayer is entitled to a deduction for the taxable year for such person under section 151 and paragraphs (3) through (8) of section 152(a) and the regulations thereunder. Under section 151 the taxpayer may be entitled to a deduction for any of the following persons:

(*a*) His brother, sister, stepbrother, or stepsister;

(*b*) His father or mother, or an ancestor of either;

(*c*) His stepfather or stepmother;

(*d*) A son or a daughter of his brother or sister;

(*e*) A brother or sister of his father or mother; or

(*f*) His son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law;

if such person has a gross income of less than the amount determined pursuant to §1.151–2 applicable to the calendar year in which the taxable year of the taxpayer begins, if the taxpayer supplies more than one-half of the support of such person for such calendar year and if such person does not make a joint return with his spouse for the taxable year beginning in such calendar year. The taxpayer may not be considered to be a head of a household by reason of any person for whom a deduction is allowed under section 151 only by reason of sections 152 (a)(9), 152 (a)(10), or 152(c) (relating to persons not related to the taxpayer, persons receiving institutional care, and persons covered by multiple support agreements).

(4) The father or mother of the taxpayer may qualify the taxpayer as a head of a household, but only if the taxpayer is entitled to a deduction for the taxable year for such father or mother under section 151 (determined without regard to section 152(c)). For example, an unmarried taxpayer who maintains a home for his widowed mother may not qualify as the head of a household by reason of his maintenance of a home for his mother if his mother has gross income equal to or in excess of the amount determined pursuant to §1.151–2 applicable to the calendar year in which the taxable year of the taxpayer begins, or if he does not furnish more than one-half of the support of his mother for such calendar year. For this purpose, a person who legally adopted the taxpayer is considered the father or mother of the taxpayer.

(5) For the purpose of this paragraph, the status of the taxpayer shall be determined as of the close of the taxpayer's taxable year. A taxpayer shall be considered as not married if at the close of his taxable year he is legally separated from his spouse under a decree of divorce or separate maintenance, or if at any time during the taxable year the spouse to whom the taxpayer is married at the close of his taxable year was a nonresident alien. A taxpayer shall be considered married at the close of his taxable year if his spouse (other than a spouse who is a nonresident alien) dies during such year.

(6) If the taxpayer is a nonresident alien during any part of the taxable year he may not qualify as a head of a household even though he may comply with the other provisions of this paragraph. See the regulations prescribed under section 871 for a definition of nonresident alien.

(c) *Household.* (1) In order for a taxpayer to be considered as maintaining a household by reason of any individual described in paragraph (a)(1) or (b)(3) of this section, the household must actually constitute the home of the taxpayer for his taxable year. A physical change in the location of such home will not prevent a taxpayer from qualifying as a head of a household. Such home must also constitute the principal place of abode of at least one of the persons specified in such paragraph (a)(1) or (b)(3) of this section. It is not sufficient that the taxpayer maintain the household without being its occupant. The taxpayer and such other person must occupy the household for the entire taxable year of the taxpayer. However, the fact that such other person is born or dies within the taxable year will not prevent the taxpayer from qualifying as a head of household if the household constitutes the principal place of abode of such other person for the remaining or preceding part of such taxable year. The taxpayer and such other person will be considered as occupying the household for such entire taxable year notwithstanding temporary absences from the household due to special circumstances. A nonpermanent failure to occupy the common abode by reason of illness, education, business, vacation, military service, or a custody agreement under which a child or stepchild is absent for less than 6 months in the taxable year of the taxpayer, shall be considered temporary absence due to special circumstances. Such absence will not prevent the taxpayer from being considered as maintaining a household if (i) it is reasonable to assume that the taxpayer or such other person will return to the household, and (ii) the taxpayer continues to maintain such household or a substantially equivalent household in anticipation of such return.

(2) In order for a taxpayer to be considered as maintaining a household by reason of any individual described in paragraph (b)(4) of this section, the household must actually constitute the principal place of abode of the taxpayer's dependent father or mother, or both of them. It is not, however, necessary for the purposes of such subparagraph for the taxpayer also to reside in such place of abode. A physical change in the location of such home will not prevent a taxpayer from qualifying as a head of a household. The father or mother of the taxpayer, however, must occupy the household for the entire taxable year of the taxpayer. They will be considered as occupying the household for such entire year notwithstanding temporary absences from the household due to special circumstances. For example, a nonpermanent failure to occupy the household by reason of illness or vacation shall be considered temporary absence due to special circumstances. Such absence will not prevent the taxpayer from qualifying as the head of a household if (i) it is reasonable to assume that such person will return to the household, and (ii) the taxpayer continues to maintain such household or a substantially equivalent household in anticipation of such return. However, the fact that the father or mother of the taxpayer dies within the year will not prevent the taxpayer from qualifying as a head of a household if the household constitutes the principal place of abode of the father or mother for the preceding part of such taxable year.

(d) *Cost of maintaining a household.* A taxpayer shall be considered as maintaining a household only if he pays more than one-half the cost thereof for his taxable year. The cost of maintaining a household shall be the expenses incurred for the mutual benefit of the occupants thereof by reason of its operation as the principal place of abode of such occupants for such taxable year. The cost of maintaining a household shall not include expenses otherwise incurred. The expenses of maintaining a household include property taxes, mortgage interest, rent, utility charges, upkeep and repairs, property insurance, and food consumed on the premises. Such expenses do not include the cost of clothing, education, medical treatment, vacations, life insurance, and transportation. In addition, the cost of maintaining a household shall not include any amount which represents the value of services rendered in the household by the taxpayer or by a person qualifying the taxpayer as a head of a household or as a surviving spouse.

(e) *Certain married individuals living apart.* For taxable years beginning after December 31, 1969, an individual who is considered as not married under section 143(b) shall be considered as not married for purposes of determining whether he or she qualifies as a single individual, a married individual, a head of household or a surviving spouse under sections 1 and 2 of the Code.

[T.D. 7117, 36 FR 9398, May 25, 1971]

§ 1.3–1 Application of optional tax.

(a) *General rules.* (1) For taxable years ending before January 1, 1970, an individual whose adjusted gross income is less than $5,000 (or a husband and wife filing a joint return whose combined adjusted gross income is less than $5,000) may elect to pay the tax imposed by section 3 in place of the tax imposed by section 1 (a) or (b). For taxable years beginning after December 31, 1969 and before January 1, 1971 an individual whose adjusted gross income is less than $10,000 (or a husband and wife filing a joint return whose combined adjusted gross income is less than $10,000) may elect to pay the tax imposed by section 3 as amended by the Tax Reform Act of 1969 in place of the tax imposed by section 1 (a) or (b). For taxable years beginning after December 31, 1970 an individual whose adjusted gross income is less than $10,000 (or a husband and wife filing a joint return whose combined adjusted gross income is less than $10,000) may elect to pay the tax imposed by section 3 as amended in place of the tax imposed by section 1 as amended. See §1.4–2 for the manner of making such election. A taxpayer may make such election regardless of the sources from which his income is derived and regardless of whether his income is computed by the cash method or the accrual method. See section 62 and the regulations thereunder for the determination of adjusted gross income. For the purpose of determining whether a taxpayer may elect to pay the tax under section 3, the amount of the adjusted gross income is controlling, without reference to the number of exemptions to which the taxpayer may be entitled. See section 4 and the regulations thereunder for additional rules applicable to section 3.

(2) The following examples illustrate the rule that section 3 applies only if the adjusted gross income is less than $10,000 ($5,000 for taxable years ending before January 1, 1970).

Example 1. A is employed at a salary of $9,200 for the calendar year 1970. In the course of such employment, he incurred travel expenses of $1,500 for which he was reimbursed during the year. Such items constitute his sole income for 1970. In such case the gross income is $10,700 but the amount of $1,500 is deducted from gross income in the determination of adjusted gross income and thus A's adjusted gross income for 1970 is $9,200. Hence, the adjusted gross income being less than $10,000, he may elect to pay his tax for 1970 under section 3. Similarly, in the case of an individual engaged in trade or business (excluding from the term "engaged in trade or business" the performance of personal services as an employee), there may be deducted from gross income in ascertaining adjusted gross income those expenses directly relating to the carrying on of such trade or business.

Example 2. If B has, as his only income for 1970, a salary of $11,600 and his spouse has no gross income, then B's adjusted gross income is $11,600 (not $11,600 reduced by exemptions of $1,250) and he is not for such year, entitled to pay his tax under section 3. If, however, B has for 1970 a salary of $13,000 and incident to his employment he incurs expenses in the amount of $3,400 for travel, meals, and lodging while away from home, for which he is not reimbursed, the adjusted gross income is $13,000 minus $3,400 or $9,600. In such case his adjusted gross income being less than $10,000, B may elect to pay the tax under section 3. However, if B's wife has adjusted gross income of $400, the total adjusted gross income is $10,000. In such case, if B and his wife file a joint return, they may not elect to pay the optional tax since the combined adjusted gross income is not less than $10,000. B may nevertheless elect to pay the optional tax, but if he makes this election he must file a separate return and, since his wife has gross income, he may not claim an exemption for her in computing the optional tax.

(b) *Surviving spouse.* The return of a surviving spouse is treated as a joint return for purposes of section 3. See section 2, and the regulations thereunder, with respect to the qualifications of a taxpayer as a surviving spouse. Accordingly, if the taxpayer qualifies as a surviving spouse and elects to pay the optional tax, he shall use the column in the tax table, appropriate to his number of exemptions, provided for cases in which a joint return is filed.

(c) *Use of tax table.* (1) To determine the amount of the tax, the individual ascertains the amount of his adjusted gross income, refers to the appropriate table set forth in section 3 or the regulations thereunder, ascertains the income bracket into which such income falls, and, using the number of exemptions applicable to his case, finds the tax in the vertical column having at the top thereof a number corresponding to the number of exemptions to which the taxpayer is entitled.

(2) Section 3(b) (relating to taxable years beginning after Dec. 31, 1964 and ending before Jan. 1, 1970) contains 5 tables for use in computing the tax. Table I is to be used by a single person who is not a head of household. Table II is to be used by a head of household. Table III is to be used by married persons filing joint returns and by a surviving spouse. Table IV is to be used by married persons filing separate returns

using the 10 percent standard deduction. Table V is to be used by married persons filing separate returns using the minimum standard deduction. For an explanation of the standard deduction see section 141 and the regulations thereunder.

(3) 30 tables are provided for use in computing the tax under the Tax Reform Act of 1969. Tables I through XV apply for taxable years beginning after December 31, 1969 and ending before January 1, 1971. Tables XVI through XXX apply for taxable years beginning after December 31, 1970. The standard deduction for Tables I through XV, applicable to taxable years beginning in 1970, is 10 percent. The standard deduction for Tables XVI through XXX, applicable to taxable years beginning in 1971, is 13 percent. For an explanation of the standard deduction and the low income allowance see section 141 as amended by the Tax Reform Act of 1969.

(4) In the case of married persons filing separate returns who qualify to use the optional tax imposed by section 3, such persons shall use the tax imposed by the table for the applicable year in accordance with the rules prescribed by sections 4(c) and 141 and the regulations thereunder governing the use and application of the standard deduction and the low income allowance.

(5) The tax shown in the tax tables set forth in section 3 or the regulations thereunder reflects full income splitting in the case of a joint return (including the return of a surviving spouse) and lesser income splitting in the case of a head of household. Therefore, it is possible for the tax shown in the tables relating to joint returns, or relating to a return of a head of a household, to be lower than that shown in the table for separate returns even though the amounts of adjusted gross income and the number of exemptions are the same.

[T.D. 7117, 36 FR 9420, May 25, 1971]

§ 1.4–1 Number of exemptions.

(a) For the purpose of determining the optional tax imposed under section 3, the taxpayer shall use the number of exemptions allowable to him as deductions under section 151. See sections 151, 152, and 153, and the regulations thereunder. In general, one exemption is allowed for the taxpayer; one exemption for his spouse if a joint return is made, or if a separate return is made by the taxpayer and his spouse has no gross income for the calendar year in which the taxable year of the taxpayer begins and is not the dependent of another taxpayer for such calendar year; and one exemption for each dependent whose gross income for the calendar year in which the taxable year of the taxpayer begins is less than the applicable amount determined pursuant to § 1.151–2. No exemption is allowed for any dependent who has made a joint return with his spouse for the taxable year beginning in the calendar year in which the taxable year of the taxpayer begins. The taxpayer may, in certain cases, be allowed an exemption for a dependent child of the taxpayer notwithstanding the fact that such child has gross income equal to or in excess of the amount determined pursuant to § 1.151–2 applicable to the calendar year in which the taxable year of the taxpayer begins. The requirements for the allowance of such an exemption are set forth in paragraph (c) of § 1.152–1. See paragraphs (c) and (d) of § 1.151–1 with respect to additional exemptions for a taxpayer or spouse who has attained the age 65 years and for a blind taxpayer or blind spouse

(b) The application of this section may be illustrated by the following examples:

Example 1. A, a married man whose duties as an employee require traveling away from his home, has as his sole gross income a salary of $5,600 for the calendar year 1954. His traveling expenses, including cost of meals and lodging, amount in such year to $750, and hence, his adjusted gross income is $4,850. His wife, B, has as her sole income interest in the amount of $85, and thus the aggregate adjusted gross income of A and B is $4,935. A has two dependent children neither of whom has any income. A and B file a joint return for 1954 on Form 1040. In such case four exemptions are allowable. The adjusted gross income falls within the tax bracket $4,900–4,950. By referring to such tax bracket in the tax table in section 3 and to the column headed ''4'' therein, the tax is found to be $407.

Example 2. C, a married man, has as his sole income in 1954 wages of $4,600, and has two dependent children neither of whom has any income. His wife, D, has adjusted gross income of $400. C files a separate return for 1954 and is entitled to claim three exemptions. C's income falls within the tax bracket $4,600–4,650 and hence, with three exemptions his tax is $480. No exemption is allowed with respect to since D has gross income and a joint return was not filed.

Example 3. D, a married man with no dependents, attains the age of 65 on September 1, 1954. The aggregate adjusted gross income of D and his wife for 1954 is $4,840. D and his wife file a joint return for 1954 and are entitled to three exemptions, one for each taxpayer and one additional exemption for D because of his age. Since the adjusted gross income of D and his wife falls within the tax bracket $4,800–4,850, the tax on a joint return is $509.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 7114, 36 FR 9018, May 18, 1971]

§ 1.4–2 Elections.

(a) *Making of election.* The election to pay the optional tax imposed under section 3 shall be made by (1) filing a return on Form 1040A, or (2) filing a return on Form 1040 and electing in such return, in accordance with the provisions of section 144 and the regulations thereunder, to take the standard deduction provided by section 141.

(b) *Election under section 3 and election of standard deduction.* Section 144 (a) and the regulations thereunder provide rules for treating an election to pay the tax under section 3 as an election to take the standard deduction, and for treating an election to take the standard deduction as an election to pay the tax under section 3. For example, if the taxpayer's return shows $5,000 or more of adjusted gross income and he elects to take the standard deduction, he will be deemed to have elected to pay the tax under section 3 if it is subsequently determined that his correct adjusted gross income is less than $5,000.

(c) [Reserved]

(d) *Change of election.* For rules relating to a change of election to pay, or not to pay, the optional tax imposed under section 3, see section 144 (b) and the regulations thereunder.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6581, 26 FR 11677, Dec. 6, 1961; T.D. 7269, 38 FR 9295, Apr. 13, 1973]

§ 1.4–3 Husband and wife filing separate returns.

(a) *In general.* If the separate adjusted gross income of a husband is less than $5,000 and the separate adjusted gross income of his wife is less than $5,000, and if each is required to file a return, the husband and the wife must each elect to pay the optional tax imposed under section 3 or neither may so elect. If the separate adjusted gross income of each spouse is $5,000 or more, then neither spouse can elect to pay the optional tax imposed under section 3. If the adjusted gross income of one spouse is $5,000 or more and that of the other spouse is less than $5,000, the election to pay the optional tax imposed under section 3 may be exercised by the spouse having adjusted gross income of less than $5,000 only if the spouse having adjusted gross income of $5,000 or more, in computing taxable income, uses the standard deduction provided by section 141. If the spouse having adjusted gross income of $5,000 or more does not use the standard deduction, then the spouse having adjusted gross income of less than $5,000 may not elect to pay the optional tax and must compute taxable income without regard to the standard deduction. Accordingly, if the spouse having adjusted gross income of $5,000 or more itemizes the deductions allowed by sections 161 and 211 in computing taxable income, the spouse having adjusted gross income of less than $5,000 must also compute taxable income by itemizing the deductions allowed by sections 161 and 211, and must pay the tax imposed by section 1. For rules relative to the election to take the standard deduction by husband and wife, see part IV (section 141 and following), subchapter B, chapter 1 of the Code, and the regulations thereunder.

(b) *Taxable years beginning after December 31, 1963, and before January 1, 1970.* (1) In the case of a husband and wife filing a separate return for a taxable year beginning after December 31, 1963, and before January 1, 1970, the optional tax imposed by section 3 shall be—

(i) For taxable years beginning in 1964, the lesser of the tax shown in Table IV (relating to the 10-percent standard deduction for married persons filing separate returns) or Table V (relating to the minimum standard deduction for married persons filing separate returns) of section 3(a), and

(ii) For a taxable year beginning after December 31, 1964, and before January 1, 1970, the lesser of the tax shown in Table IV (relating to the 10-percent standard deduction for married persons filing separate returns) or Table V (relating to minimum standard deduction for married persons filing separate returns) of section 3(b).

(2) If the tax of one spouse is determined with regard to the 10-percent standard deduction provided for in Table IV of section 3(a) or 3(b) or if such spouse in computing taxable income uses the 10-percent standard deduction provided for in section 141(b), then the minimum standard deduction provided for in Table V of section 3(a) or 3(b) shall not apply in the case of the other spouse, if such spouse elects to pay the optional tax imposed under section (3). Thus, if a husband and wife compute their tax with reference to the standard deduction, one cannot elect to use the 10-percent standard deduction and the other elect to use the minimum standard deduction. However, an individual described in section 141(d)(2) may elect pursuant to such section and the regulations thereunder to pay the tax shown in Table V of section 3(a) or 3(b) in lieu of the tax shown in Table IV of section 3(a) or 3(b). See section 141(d) and the regulations thereunder for rules relating to the standard deduction in the case of married individuals filing separate returns.

(c) *Taxable years beginning after December 31, 1969.* (1) In the case of a husband and wife filing a separate return for a taxable year beginning after December 31, 1969, the optional tax imposed by section 3 shall be the lesser of the tax shown in—

(i) The table prescribed under section 3 applicable to such taxable year in the case of married persons filing separate returns which applies the percentage standard deduction, or

(ii) The table prescribed under section 3 applicable to such taxable year in the case of married persons filing separate returns which applies the low income allowance.

(2) If the tax of one spouse is determined by the table described in subparagraph (1)(i) of this paragraph or if such spouse in computing taxable income uses the percentage standard deduction provided for in section 141(b), then the table described in subparagraph (1)(ii) of this paragraph shall not apply in the case of the other spouse, if such other spouse elects to pay the optional tax imposed under section 3. Thus, if a husband and wife compute the tax with reference to the standard deduction, one cannot elect to use the percentage standard deduction and the other elect to use the low income allowance. A married individual described in section 141(d)(2) may elect pursuant to such section and the regulations thereunder to pay the tax shown in the table described by subparagraph (1)(ii) of this paragraph in lieu of the tax shown in the table described by subparagraph (1)(i) of this paragraph. See section 141(d) and the regulations thereunder for rules relating to the standard deduction in the case of married individuals filing separate returns.

(d) *Determination of marital status.* For the purpose of applying the restrictions upon the right of a married person to elect to pay the tax under section 3, (1) the determination of marital status is made as of the close of the taxpayer's taxable year or, if his spouse died during such year, as of the date of death; (2) a person legally separated from his spouse under a decree of divorce or separate maintenance on the last day of his taxable year (or the date of death of his spouse, whichever is applicable) is not considered as married; and (3) with respect to taxable years beginning after December 31, 1969, a person, although considered as married within the meaning of section 143(a), is considered as not married if he lives apart from his spouse and satisfies the requirements set forth in section 143(b). See section 143 and the regulations thereunder.

[T.D. 6792, 30 FR 529, Jan. 15, 1965, as amended by T.D. 7123, 36 FR 11084, June 9, 1971]

§ 1.4–4 Short taxable year caused by death.

An individual making a return for a period of less than 12 months on account of a change in his accounting period may not elect to pay the optional tax under section 3. However, the fact that the taxable year is less than 12 months does not prevent the determination of the tax for the taxable year under section 3 if the short taxable year results from the death of the taxpayer.

TAX ON CORPORATIONS

§ 1.11–1 Tax on corporations.

(a) Every corporation, foreign or domestic, is liable to the tax imposed under section 11 except (1) corporations specifically excepted under such section from such tax; (2) corporations expressly exempt from all taxation under subtitle A of the Code (see section 501); and (3) corporations subject to tax under section 511(a). For taxable years beginning after December 31, 1966, foreign corporations engaged in trade or business in the United States shall be taxable under section 11 only on their taxable income which is effectively connected with the conduct of a trade or business in the United States (see section 882(a)(1)). For definition of the terms ''corporations,'' ''domestic,'' and ''foreign,'' see section 7701(a) (3), (4), and (5), respectively. It is immaterial that a domestic corporation, and for taxable years beginning after December 31, 1966, a foreign corporation engaged in trade or business in the United States, which is subject to the tax imposed by section 11 may derive no income from sources within the United States. The tax imposed by section 11 is payable upon the basis of the returns rendered by the corporations liable thereto, except that in some cases a tax is to be paid at the source of the income. See subchapter A (sections 6001 and following), chapter 61 of the Code, and section 1442.

(b) The tax imposed by section 11 consists of a normal tax and a surtax. The normal tax and the surtax are both computed upon the taxable income of the corporation for the taxable year, that is, upon the gross income of the corporation minus the deductions allowed by chapter 1 of the Code. However, the deduction provided in section 242 for partially tax-exempt interest is not allowed in computing the taxable income subject to the surtax.

(c) The normal tax is at the rate of 22 percent and is applied to the taxable income for the taxable year. However, in the case of a taxable year ending after December 31, 1974, and before January 1, 1976, the normal tax is at the rate of 20 percent of so much of the taxable income as does not exceed $25,000 and at the rate of 22 percent of so much of the taxable income as does exceed $25,000 and is applied to the taxable income for the taxable year.

(d) The surtax is at the rate of 26 percent and is upon the taxable income (computed without regard to the deduction, if any, provided in section 242 for partially tax-exempt interest) in excess of $25,000. However, in the case of a taxable year ending after December 31, 1974, and before January 1, 1976, the surtax is upon the taxable income (computed as provided in the preceding sentence) in excess of $50,000. In certain circumstances the exemption from surtax may be disallowed in whole or in part. See sections 269, 1551, 1561, and 1564 and the regulations thereunder. For purposes of sections 244, 247, 804, 907, 922 and §§1.51–1 and 1.815–4, when the phrase ''the sum of the normal tax rate and the surtax rate for the taxable year'' is used in any such section, the normal tax rate for all taxable years beginning after December 31, 1963, and ending before January 1, 1976, shall be considered to be 22 percent.

(e) The computation of the tax on corporations imposed under section 11 may be illustrated by the following example:

Example. The X Corporation, a domestic corporation, has gross income of $86,000 for the calendar year 1964. The gross income includes interest of $5,000 on United States obligations for which a deduction under section 242 is allowable in determining taxable income subject to the normal tax. It has other deductions of $11,000. The tax of the X Corporation under section 11 for the calendar year is $28,400 ($15,400 normal tax and $13,000 surtax) computed as follows:

COMPUTATION OF NORMAL TAX

Gross income		$86,000
Deductions:		
Partially tax-exempt interest	$5,000	

Other	11,000	16,000
Taxable income	70,000	
Normal tax (22 percent of $70,000)	15,400	
COMPUTATION OF SURTAX		
Taxable income	70,000	
Add: Amount of partially tax-exempt interest deducted in computing taxable income	5,000	
Taxable income subject to surtax	75,000	
Less: Exemption from surtax	25,000	
Excess of taxable income subject to surtax over exemption	50,000	
Surtax (26 percent of $50,000)	13,000	

(f) For special rules applicable to foreign corporations engaged in trade or business within the United States, see section 882 and the regulations thereunder. For additional tax on personal holding companies, see part II (section 541 and following), subchapter G, chapter 1 of the Code, and the regulations thereunder. For additional tax on corporations improperly accumulating surplus, see part I (section 531 and following), subchapter G, chapter 1 of the Code, and the regulations thereunder. For treatment of China Trade Act corporations, see sections 941 and 942 and the regulations thereunder. For treatment of Western Hemisphere trade corporations, see sections 921 and 922 and the regulations thereunder. For treatment of capital gains and losses, see subchapter P (section 1201 and following), chapter 1 of the Code. For computation of the tax for a taxable year during which a change in the tax rates occurs, see section 21 and the regulations thereunder.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 7293, 38 FR 32792, Nov. 28, 1973; T.D. 74–13, 41 FR 12639, Mar. 26, 1976]

CHANGES IN RATES DURING A TAXABLE YEAR

§ 1.15–1 Changes in rate during a taxable year.

(a) Section 21 applies to all taxpayers, including individuals and corporations. It provides a general rule applicable in any case where (1) any rate of tax imposed by chapter 1 of the Code upon the taxpayer is increased or decreased, or any such tax is repealed, and (2) the taxable year includes the effective date of the change, except where that date is the first day of the taxable year. For example, the normal tax on corporations under section 11(b) was decreased from 30 percent to 22 percent in the case of a taxable year beginning after December 31, 1963. Accordingly, the tax for a taxable year of a corporation beginning on January 1, 1964, would be computed under section 11(b) at the new rate without regard to section 21. However, for any taxable year beginning before January 1, 1964, and ending on or after that date, the tax would be computed under section 21. For additional circumstances under which section 21 is not applicable, see paragraph (k) of this section.

(b) In any case in which section 21 is applicable, a tentative tax shall be computed by applying to the taxable income for the entire taxable year the rate for the period within the taxable year before the effective date of change, and another tentative tax shall be computed by applying to the taxable income for the entire taxable year the rate for the period within the taxable year on or after such effective date. The tax imposed on the taxpayer is the sum of—

(1) An amount which bears the same ratio to the tentative tax computed at the rate applicable to the period within the taxable year before the effective date of the change that the number of days in such period bears to the number of days in the taxable year, and

(2) An amount which bears the same ratio to the tentative tax computed at the rate applicable to the period within the taxable year on and after the effective date of the change that the number of days in such period bears to the number of days in the taxable year.

(c) If the rate of tax is changed for taxable years "beginning after" or "ending after" a certain date, the following day is considered the effective date of the change for purposes of section 21. If the rate is changed for taxable years "beginning on or after" a certain date, that date is considered the effective date of the change for purposes of section 21. This rule may be illustrated by the following examples:

Example 1. Assume that the law provides that a change in a certain rate of tax shall be effective only with respect to taxable years beginning after December 31, 1969. The effective date of change for purposes of section 21 is January 1, 1970, and section 21 must be applied to any taxable year which begins before and ends on or after January 1, 1970.

Example 2. Assume that the law provides that a change in a certain rate of tax shall be applicable only with respect to taxable years ending after December 31, 1970. For purposes of section 21, the effective date of change is January 1, 1971, and section 21 must be applied to any taxable year which begins before and ends on or after January 1, 1971.

Example 3. Assume that the law provides that a change in a certain rate of tax shall be effective only with respect to taxable years beginning on or after January 1, 1971. The effective date of change for purposes of section 21 is January 1, 1971, and section 21 must be applied to any taxable year which begins before and ends on or after January 1, 1971.

(d) If a tax is repealed, the repeal will be treated as a change of rate for purposes of section 21, and the rate for the period after the repeal (for purposes of computing the tentative tax with respect to that period) will be considered zero. For example, the Tax Reform Act of 1969 repealed section 1562, which imposed a 6 percent additional tax on controlled corporations electing multiple surtax exemptions, effective for taxable years beginning after December 31, 1974. For such controlled corporations having taxable years beginning in 1974 and ending in 1975, the rate for the period ending before January 1, 1975, would be 6 percent; the rate for the period beginning after December 31, 1974, would be zero. However, subject to the rules stated in this section, section 21 does not apply to the imposition of a new tax. For example, if a new tax is imposed for taxable years beginning on or after July 1, 1972, a computation under section 21 would not be required with respect to such new tax in the case of taxable years beginning before July 1, 1972, and ending on or after that date. If the effective date of the imposition of a new tax and the effective date of a change in rate of such tax fall in the same taxable year, section 21 is not applicable in computing the taxpayer's liability for such tax for such year unless the new tax is expressly imposed upon the taxpayer for a portion of his taxable year prior to the change in rate.

(e) If a husband and wife have different taxable years because of the death of either spouse, and if a joint return is filed with respect to the taxable year of each, then, for purposes of section 21, the joint return shall be treated as if the taxable years of both spouses ended on the date of the closing of the surviving spouse's taxable year. See section 6013 (c), relating to treatment of joint return after death of either spouse. Accordingly, if a change in the rate of tax is effective during the taxable year of the surviving spouse, the tentative taxes with respect to the joint return shall be computed on the basis of the number of days during which each rate of tax was in effect for the taxable year of the surviving spouse.

(f) Section 21 applies whether or not the taxpayer has a taxable year of less than 12 months. Moreover, section 21 applies whether or not the taxable income for a taxable year of less than 12 months is required to be placed on an annual basis under section 443. If the taxable income is required to be computed under section 443(b) then the tentative taxes under section 21 are computed as provided in paragraph (1) or (2) of section 443(b) and are reduced as provided in those paragraphs. The tentative taxes so computed and reduced are then apportioned as provided in section 21(a)(2) to determine the tax for such taxable year as computed under section 21.

(g) If a taxpayer has made the election under section 441(f) (relating to computation of taxable income on the basis of an annual accounting period varying from 52 to 53 weeks), the rules provided in section 441(f)(2) shall be applicable for purposes of determining whether section 21 applies to the taxable year of the taxpayer. Where a taxpayer has made the election under section 441(f) and where section 21 applies to the taxable year of the taxpayer the computation under section 21(a)(2) shall be made upon the basis of the actual number of days in the taxable year and in each period thereof.

(h)(1) Section 21 is applicable only if the rate of tax imposed by chapter 1 changes. Sections in which rates of tax are specified or incorporated by reference include the following: 1, 2, 3, 11, 511, 531, 541, 821, 831, 871, 881, 1201, and 1348 (for taxable years beginning after December 31, 1970). Except as provided in subparagraph (3) of this paragraph, section 21 is not applicable with respect to changes in the law relating to deductions from gross income, exclusions from or inclusions in gross income, or other items taken into account in determining the amount or character of income subject to tax. Moreover, section 21 is not applicable with respect to changes in the law relating to credits against the tax or with respect to changes in the law relating to limitations on the amount of tax. Section 21 is applicable, however, to all those computations specified in the section providing the rate of tax which are implicit in determining the rate. For example, if one of the tax brackets in the tax tables under section 3 were to be changed, section 21 would be applicable to that change. Thus, if the bracket relating to ''at least $4,200 but not less than $4,250'' for heads of households should be changed to increase or decrease the last sum specified, with corresponding changes being made in subsequent brackets, section 21 would be applicable. The enactment of sections 1561 and 1562 is considered a change in section 11(d) which constitutes a change in rate for the period ending after December 31, 1963. The amendment of section 1561 and the repeal of section 1562 by the Tax Reform Act of 1969 is considered a change in section 11(d) which constitutes a change in rate for the period ending after December 31, 1974. The repeal of the 2 percent additional tax imposed under section 1503 on corporations filing consolidated returns constitutes a change in rate for the period ending after December 31, 1963. The addition to the Code of section 1348 (relating to 50 percent maximum rate on earned income) is a change in rate to which section 21(a) is applicable. The amendment of section 11(d) by the Tax Reduction Act of 1975 which increases to $50,000 the surtax exemption for a taxable year ending during 1975 constitutes a change in rate for such portion of the taxable year (if less than the entire taxable year) as follows December 31, 1974. Similarly, the return of the surtax exemption to $25,000 for a taxable year ending during 1976 constitutes a change in rate for such portion of the taxable year (if less than the entire taxable year) as follows December 31, 1975.

(2) Ordinarily, both the old and the new rates are applied to the same amount of taxable income. However, where the rate of tax is itself taken into account in determining taxable income (for example, the special deduction for Western Hemisphere trade corporations under section 922), the taxable income used in determining the tentative tax employing the rate before the effective date of change shall be determined by reference to that rate of tax, and the taxable income for the purpose of determining the tentative tax employing the rate for the period on and after the effective date of the change shall be determined by reference to the new tax rate.

(3) Section 21 is applicable with respect to changes in the law relating to the standard deduction for individuals provided in part IV of subchapter B and to the deduction for personal exemptions for individuals provided in part V of subchapter B.

(i) If the rate of tax changes more than once during the taxable year, section 21 is applicable to each change in rate. For example, if the rate of normal tax changed for taxable years beginning on or after March 1, 1954, and changed again for taxable years beginning on or after June 1, 1954, section 21 requires computation of 3 tentative taxes for any taxable year which began before March 1, 1954, and ended on or after June 1, 1954: One tentative tax at the rate in effect before the March 1 change; another tentative tax at the rate in effect from March 1 to May 31; and a third tentative tax at the rate in effect from June 1 to the end of the taxable year. The proportion of each such tentative tax taken into account in determining the tax imposed on the taxpayer is computed by reference to the portion of the taxable year before March 1, 1954, by reference to the portion of the taxable year from March 1, 1954, through May 31, 1954, and by reference to the portion of the taxable year from June 1, 1954, to the end of the taxable year, respectively.

(j)(1) If a change in the rate of one tax imposed by chapter 1 of the Code does not affect the amount of other taxes imposed by chapter 1 of the Code the other taxes may be determined without regard to section 21 and section 21 will be applied only to the tax for which a change in rate is made. However, if the change of rate of one tax does affect the amount of other taxes imposed under chapter 1 of the Code, then the computation of the taxes under chapter 1 of the Code so affected shall be made by applying section 21. For example, if section 1201 applies to an individual taxpayer for a taxable year containing the effective date of a change in a rate of tax provided in section 1, then under section 21 the taxpayer must compute a tentative tax for each period for which a different rate of tax is effective under section 1. The tentative tax for each such period as computed under section 1201 will reflect the rate of tax provided by section 1 for such period.

(2) In certain cases chapter 1 of the Code provides that the particular tax to be imposed upon the taxpayer shall be one of several taxes, the basis of selection being the tax that is greater or lesser. See, for example, sections 821 and 1201. If in any such case the rate of any one of these taxes changes, then the tentative taxes computed as provided by section 21 for each period shall be computed employing the tax selected in accordance with the general rule of selection for such a case, at the rate of tax in effect for such period. Thus, if a change in the rate of the alternative tax under section 1201 is such that the alternative tax under section 1201 is applicable if the old rate is used and is not applicable if the new rate is used, one tentative tax will consist of the alternative tax under section 1201 and the other tentative tax will consist of the tax imposed by the other applicable sections of chapter 1 of the Code. The two tentative taxes so computed are then prorated in accordance with section 21(a)(2) and the sum of the proportionate amounts is the tax imposed for the taxable year under chapter 1 of the Code. See the examples in paragraph (n) of this section.

(k) Section 21 does not apply in the following situations:

(1) The provisions of section 21 do not apply to the imposition of the tax surcharge by section 51. The proration rules of section 51(a) apply in the case of a taxable year ending on or after the effective date of the surcharge and beginning before July 1, 1970.

(2) The provisions of section 21 do not apply to the imposition of the minimum tax for tax preferences by section 56. The proration rules of section 301(c) of the Tax Reform Act of 1969 (83 Stat. 586) apply in the case of a taxable year beginning in 1969 and ending in 1970.

(l) In computing the number of days each rate of tax is in effect during the taxable year for purposes of section 21(a)(2), the effective date of the change in rate shall be counted in the period for which the new rate is in effect.

(m) Any credits against tax, and any limitation in any credit against tax, shall be based upon the tax computed under section 21. For credits against tax, see part IV (section 31 and following), subchapter A, chapter 1 of the Code.

(n) The application of section 21 may be illustrated by the following examples: (See also the examples in § 1.1561–2A(a)(3).)

Example 1. A, a married taxpayer filing a joint return, reports his income on the basis of a fiscal year ending June 30. For his fiscal year ending June 30, 1970, A reports taxable income (exclusive of capital gains and losses) of $50,000 and net long-term capital gain (section 1201 gain (net capital gain for taxable years beginning after December 31, 1976)) of $75,000. The rate of tax on capital gains under section 1201(b) relating to the alternative tax has been increased from 25 percent to a maximum rate of 29½ percent with respect to gain in excess of $50,000 and the effective date of the change in rate is January 1, 1970. The income tax for the taxable year ended June 30, 1970, would be computed under section 21 as follows:

	Tentative Tax
Taxable income exclusive of capital gains and losses ..	$50,000
Long-term capital gain	75,000
	125,000
Deduct 50% of long-term capital gain ...	37,500
Taxable income	87,500
Tax under section 1 (1969 and 1970 rates)	37,690

ALTERNATIVE TAX UNDER SECTION 1201(b) (1969 RATES)

Taxable income ($50,000 + 50% of $75,000)	$87,500
Less 50% of long-term capital gain	37,500
Taxable income exclusive of capital gains	50,000
Partial tax (tax on $50,000)	17,060
Plus 25% of $75,000	18,750
Alternative tax under section 1201(b) at 1969 rates	35,810

ALTERNATIVE TAX UNDER SECTION 1201(b) (1970 RATES)

STEP I		
Taxable income ($50,000 + 50% of $75,000)	$87,500	
Deduct 50% of net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976)	37,500	
	50,000	
Tax on $50,000 (taxable income exclusive of capital gains)		$17,060
STEP II		
(a) Net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976)	75,000	
(b) Subsection (d) gain	50,000	
25% of $50,000 (lesser of (a) or (b))		12,500
STEP III		
(c) 29½% of $25,000 (excess of (a) over (b))	7,375	
(d) Ordinary income	$50,000	
50% of net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976)	37,500	
	87,500	
Tax on $87,500	$37,690	
Ordinary income	$50,000	
50% of subsection (d) gain	25,000	
	75,000	
Tax on $75,000	30,470	
Difference	7,220	
Lesser of (c) or (d)	$7,220	
Alternative tax (total of 3 steps) at rates effective on and after January 1, 1970		36,780

Since the alternative tax is less than the tax imposed under section 1 for both the period in 1969 and the period in 1970, the alternative tax applies for both periods. Thus, since the effective date of the change in the rate of tax on capital gains is January 1, 1970, the old rate of alternative tax is effective for 184 days of the taxable year and the new rate of alternative tax is effective for 181 days of the taxable year. The alternative taxes are apportioned as follows:

1969—184/365 of $35,810	$18,052.16
1970—181/365 of $36,780	18,238.85
	36,291.01
Tax surcharge (See § 1.51–1(d)(1)(i))	2,729.28
Total tax for the taxable year	39,020.29

Example 2. B, a single individual not a head of a household, has a taxable year ending March 31. For the taxable year ending March 31, 1971, B has adjusted gross income of $18,500. His computation of the tax imposed is as follows:

1970 TENTATIVE TAX		
Adjusted gross income	$18,500.00	
Less:		
Standard deduction	$1,000.00	
Personal exemption	625.00	1,625.00
Taxable income under 1970 deduction provisions	16,875.00	
Tax on $16,875 (1970 rates):		
Tax on first $16,000	4,330.00	
42 percent of $875	367.50	
Tentative tax at rates and deduction provisions effective on or after January 1, 1970	4,697.50	
1971 TENTATIVE TAX		
Adjusted gross income	$18,500.00	
Less:		
Standard deduction	$1,500	
Personal exemption	650	2,150.00
Taxable income under 1971 deduction provisions	16,350.00	
Tax on $16,350 (1971 rates):		
Tax on first $16,000	3,830	
34 percent of $350	119	
Tentative tax at rates and deduction provisions effective on or after Januray 1, 1971	3,949.00	
The 1970 and 1971 tentative taxes are apportioned as follows:		
1970—275/365 of $4,697.50	3,539.21	
1971—90/365 of $3,949.00	973.73	
	4,512.94	
Tax surcharge (see § 1.51–1(d)(1)(i))	56.26	

Total tax for the taxable year	4,569.20	

Example 3. H and W, husband and wife, have a foster child, C, who qualifies as a dependent under section 152(b)(2) for the period beginning after December 31, 1969. H and W file a joint return on the basis of a taxable year ending August 31. For the taxable year ending August 31, 1970, H and W have adjusted gross income of $12,500. Their computation of the tax imposed is as follows:

1969 TENTATIVE TAX

Adjusted gross income	$12,500.00	
Less:		
Standard deduction	$1,000.00	
Personal exemption (2)	1,200.00	2,200.00
Taxable income under 1969 deduction provisions	10,300.00	
Taxable income reduced by one-half		5,150.00
Tax on $5,150 (1969 rates):		
Tax on first $4,000	$690.00	
22 percent of $1,150	253.00	943.00
Twice the tax on $5,150	$1,886.00	
Tentative tax at rates and deduction provisions effective on or after January 1, 1969	1,886.00	

1970 TENTATIVE TAX

Adjusted gross income	$12,500.00	
Less:		
Standard deduction	$1,000.00	
Personal exemption (3)	1,875.00	2,875.00
Taxable income under 1970 deduction provisions	$9,625.00	
Tax on $9,625 (1970 rates):		
Tax on first $8,000	$1,380.00	
22 percent of $1,625	357.50	
Tentative tax at rates and deduction provisions effective on or after January 1, 1970	1,737.50	
The 1969 and 1970 tentative taxes are apportioned as follows:		
1969—122/365 of $1,886	$630.39	
1970—243/365 of $1,737.50	1,156.75	
	1,787.14	
Tax surcharge (see § 1.51–1(d)(1)(i))	104.05	
Total tax for the taxable year	1,891.19	

Example 4. B, a single individual with one exemption, reports his income on the basis of a fiscal year ending June 30. For fiscal year ending June 30, 1971, B reports adjusted gross income of $250,000, consisting of earned net income of $240,000 and investment income of $10,000. In addition, on April 24, 1971, stock was transferred to B pursuant to his exercise of a qualified stock option, and the fair market value of such stock at that time exceeded the option price by $175,000. This $175,000 constitutes an item of tax preference described in section 57(a)(6). B claims itemized deductions in the amount of $34,000. By reason of section 1348, the maximum rate of tax on earned taxable income for a taxable year beginning after 1970 but before 1972 is 60 percent. The income tax for the taxable year ending June 30, 1971, would be computed under section 21 as follows:

1970 TENTATIVE TAX

Adjusted gross income	$250,000.00	
Less:		
Itemized deductions	$34,000.00	
Personal exemption	625.00	34,625.00
Taxable income under 1970 deduction provisions	215,375.00	
Tax on $215,375 (1970 rates)		
Tax on first $100,000	$55,490.00	
70 percent of $115,375	80,762.50	
Tentative tax at rates and deduction provisions effective on or after January 1, 1970	136,252.50	
Minimum tax:		
Total tax preference items	175,000.00	
Less:		
Exemption	$30,000.00	
Income tax	136,252.50	166,252.50
Subject to 10 percent tax	8,747.50	
10 percent tax	874.75	
Total tentative tax ($136,252.50 + $874.75)	137,127.25	

1971 TENTATIVE TAX

Adjusted gross income	$250,000.00	
Less:		
Itemized deductions	$34,000.00	
Personal exemption	650.00	34,650.00
Taxable income under 1971 deduction provisions	215,350.00	
(a) Tax on highest amount of taxable income on which rate does not exceed 60 percent ($50,000) (1971 rates)	20,190.00	
(b) Earned taxable income: ($215,350 × $240,000/$250,000)	$206,736.00	
Less: Tax preference offset: ($175,000 − $30,000)	145,000.00	
	61,736.00	
(c) 60% of the amount by which $61,736 exceeds $50,000	7,041.60	

(d) Tax on $215,350 (1971 rates)		
Tax on first $100,000	53,090.00	
70% of $115,350	80,745.00	
Total	133,835.00	
(e) Tax on $61,736 (1971 rates)		
Tax on first $60,000	26,390.00	
64% of $1,736	1,111.04	
Total	27,501.04	
(f) Excess of $133,835 over $27,501.04	106,333.96	
Tentative tax (total of Steps (a), (c), and (f)) at rates and deduction provisions effective on or after January 1, 1971	133,565.56	
Minimum tax:		
Total tax preference items	175,000.00	
Less:		
Exemption	$30,000.00	
Income tax	133,565.56	163,565.56
Subject to 10 percent tax	$11,434.44	
10 percent tax	1,143.44	
Total tentative tax ($133,565.56 + $1,143.44)	134,709.00	
The 1970 and 1971 tentative taxes are apportioned as follows:		
1970—184/365 of $137,127.25	69,127.16	
1971—181/365 of $134,709	66,800.90	
Total tax for the taxable year	135,928.06	

Example 5. The surtax exemption of corporation M (one of 4 subsidiary corporations of W corporation), which files its income tax returns on the basis of a fiscal year ending March 31, 1964, is less than $25,000, by reason of section 1561 of the Code applicable to taxable years ending after December 31, 1963, and beginning before January 1, 1975. The taxable income of corporation M is $100,000, and the amount of the surtax exemption determined under the new rule for the 1964 taxable year is $5,000 ($25,000 ÷ 5). M's income tax liability for the taxable year ending March 31, 1964, is computed as follows:

1963 TENTATIVE TAX

Taxable income	$100,000
Normal tax on $100,000 (1963 rates) 30 percent of $100,000	$30,000
Surtax on $75,000 (1963 rates and $25,000 surtax exemption) 22 percent of $75,000	16,500
Total tentative tax at rates and surtax exemption effective before January 1, 1964	46,500

1964 TENTATIVE TAX

Taxable income	$100,000
Normal tax on $100,000 (1964 rates) 22 percent of $100,000	$22,000
Surtax on $95,000 (1964 rates and a $5,000 surtax exemption) 28 percent of $95,000	26,600
Total tentative tax at rates and surtax exemption effective after January 1, 1964	48,600
The 1963 and 1964 tentative taxes are apportioned as follows:	
1963—275/366 of $46,500	34,938.52
1964—91/366 of $48,600	12,083.61
Total tax for the taxable year	47,022.13

M has the same amount of taxable income in 1965. Its income tax liability for the fiscal year ending March 31, 1965, is computed as follows:

1964 TENTATIVE TAX

Taxable income	$100,000
Normal tax on $100,000 (1964 rates) 22 percent of $100,000	$22,000
Surtax on $95,000 (1964 rates and a $5,000 surtax exemption) 28 percent of $95,000	26,600
Total tentative tax at the 1964 rates	48,600

1965 TENTATIVE TAX

Taxable income	$100,000
Normal tax on $100,000 (1965 rates) 22 percent of $100,000	$22,000
Surtax on $95,000 (1965 rates and a $5,000 surtax exemption) 26 percent of $95,000	24,700
Total tentative tax at the 1965 rates	46,700
The 1964 and 1965 tentative taxes are apportioned as follows:	
1964—275/365 of $48,600	$36,616.44
1965—90/365 of $46,700	11,515.07
Total tax for the taxable year	48,131.51

Example 6. Assume the same facts as in example (5), except that M elected the additional tax under section 1562 for its fiscal year ending March 31, 1964. M's tax liability is completed as follows:

1963 TENTATIVE TAX

Taxable income	$100,000
Normal tax on $100,000 (1963 rates) 30 percent of $100,000	$30,000
Surtax on $75,000 (1963 rates and $25,000 surtax exemption) 22 percent of $75,000	16,500
Total tentative tax at rates and surtax exemption effective before January 1, 1964	46,500

1964 TENTATIVE TAX

Taxable income	$100,000
Normal tax on $100,000 (1964 rates) 22 percent of $100,000	$22,000
Surtax on $75,000 (1964 rates and $25,000 surtax exemption) 28 percent of $75,000	21,000
Additional tax on $25,000 6 percent of $25,000	1,500
Total tentative tax at rates and surtax exemption effective on and after January 1, 1964	44,500
The 1963 and 1964 tentative taxes are apportioned as follows:	
1963—275/366 of $46,500	$34,938.52
1964—91/366 of $44,500	11,064.21
Total tax for the taxable year	46,002.73

Example 7. Corporation N files its income tax returns on the basis of a fiscal year ending June 30. For its taxable year ending in 1976, the taxable income of N is $100,000. N's income tax liability is determined for the period July 1, 1975, through December 31, 1975, by taking into account two rates of normal tax under section 11(b)(2) (A) and (B) and the increase to $50,000 in the surtax exemption under section 11(d). For the period January 1, 1976, through June 30, 1976, N's income tax liability is determined by taking into account the single normal tax rate under section 11(b)(1) and the $25,000 surtax exemption under section 11(d). N's tax liability for the taxable year ending June 30, 1976, is computed as follows:

1975 TENTATIVE TAX

Taxable income	$100,000
Normal tax on $100,000 (1975 rates) 20 percent of $25,000	$5,000
22 percent of $75,000	16,500
Surtax on $50,000 (1975 rates and $50,000 surtax exemption) 26 percent of $50,000	13,000
Total tentative tax at rates and surtax exemption effective on and after January 1, 1975	34,500

1976 TENTATIVE TAX

Taxable income	$100,000
Normal tax on $100,000 (1976 rates) 22 percent of $100,000	$22,000
Surtax on $75,000 (1976 rates and $25,000 surtax exemption) 26 percent of $75,000	19,500
Total tentative tax at rates and surtax exemption effective on and after January 1, 1976	41,500
The 1975 and 1976 tentative taxes are apportioned as follows:	
1975—184/366 of $34,500	$17,344
1976—182/366 of $41,500	20,637
Total tax for the taxable year	37,981

(Secs. 1561(a) (83 Stat. 599; 26 U.S.C. 1561(a)) of the Internal Revenue Code)

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7164, 37 FR 4190, Feb. 29, 1972; T.D. 74–13, 41 FR 12639, Mar. 26, 1976; T.D. 7528, 42 FR 64694, Dec. 28, 1977; T.D. 7728, 45 FR 72651, Nov. 3, 1980. Redesignated by T.D. 9354, 72 FR 45341, Aug. 14, 2007]

§ 1.21–1 Expenses for household and dependent care services necessary for gainful employment.

(a) *In general.* (1) Section 21 allows a credit to a taxpayer against the tax imposed by chapter 1 for employment-related expenses for household services and care (as defined in paragraph (d) of this section) of a qualifying individual (as defined in paragraph (b) of this section). The purpose of the expenses must be to enable the taxpayer to be gainfully employed (as defined in paragraph (c) of this section). For taxable years beginning after December 31, 2004, a qualifying individual must have the same principal place of abode (as defined in paragraph (g) of this section) as the taxpayer for more than one-half of the taxable year. For taxable years beginning before January 1, 2005, the taxpayer must maintain a household (as defined in paragraph (h) of this section) that includes one or more qualifying individuals.

(2) The amount of the credit is equal to the applicable percentage of the employment-related expenses that may be taken into account by the taxpayer during the taxable year (but subject to the limits prescribed in § 1.21–2). *Applicable percentage* means 35 percent reduced by 1 percentage point for each $2,000 (or fraction thereof) by which the taxpayer's adjusted gross income for the taxable year exceeds $15,000, but not less than 20 percent. For example, if a taxpayer's adjusted gross income is $31,850, the applicable percentage is 26 percent.

(3) Expenses may be taken as a credit under section 21, regardless of the taxpayer's method of accounting, only in the taxable year the services are performed or the taxable year the expenses are paid, whichever is later.

(4) The requirements of section 21 and §§ 1.21–1 through 1.21–4 are applied at the time the services are performed, regardless of when the expenses are paid.

(5) *Examples*. The provisions of this paragraph (a) are illustrated by the following examples.

Example 1. In December 2007, B pays for the care of her child for January 2008. Under paragraph (a)(3) of this section, B may claim the credit in 2008, the later of the years in which the expenses are paid and the services are performed.

Example 2. The facts are the same as in *Example 1*, except that B's child turns 13 on February 1, 2008, and B pays for the care provided in January 2008 on February 3, 2008. Under paragraph (a)(4) of this section, the determination of whether the expenses are employment-related expenses is made when the services are performed. Assuming other requirements are met, the amount B pays will be an employment-related expense under section 21, because B's child is a qualifying individual when the services are performed, even though the child is not a qualifying individual when B pays the expenses.

(b) *Qualifying individual*—(1) *In general*. For taxable years beginning after December 31, 2004, a qualifying individual is—

(i) The taxpayer's dependent (who is a qualifying child within the meaning of section 152) who has not attained age 13;

(ii) The taxpayer's dependent (as defined in section 152, determined without regard to subsections (b)(1), (b)(2), and (d)(1)(B)) who is physically or mentally incapable of self-care and who has the same principal place of abode as the taxpayer for more than one-half of the taxable year; or

(iii) The taxpayer's spouse who is physically or mentally incapable of self-care and who has the same principal place of abode as the taxpayer for more than one-half of the taxable year.

(2) *Taxable years beginning before January 1, 2005*. For taxable years beginning before January 1, 2005, a qualifying individual is—

(i) The taxpayer's dependent for whom the taxpayer is entitled to a deduction for a personal exemption under section 151(c) and who is under age 13;

(ii) The taxpayer's dependent who is physically or mentally incapable of self-care; or

(iii) The taxpayer's spouse who is physically or mentally incapable of self-care.

(3) *Qualification on a daily basis*. The status of an individual as a qualifying individual is determined on a daily basis. An individual is not a qualifying individual on the day the status terminates.

(4) *Physical or mental incapacity*. An individual is physically or mentally incapable of self-care if, as a result of a physical or mental defect, the individual is incapable of caring for the individual's hygiene or nutritional needs, or requires full-time attention of another person for the individual's own safety or the safety of others. The inability of an individual to engage in any substantial gainful activity or to perform the normal household functions of a homemaker or care for minor children by reason of a physical or mental condition does not of itself establish that the individual is physically or mentally incapable of self-care.

(5) *Special test for divorced or separated parents or parents living apart*—(i)

Scope. This paragraph (b)(5) applies to a child (as defined in section 152(f)(1) for taxable years beginning after December 31, 2004, and in section 151(c)(3) for taxable years beginning before January 1, 2005) who—

(A) Is under age 13 or is physically or mentally incapable of self-care;

(B) Receives over one-half of his or her support during the calendar year from one or both parents who are divorced or legally separated under a decree of divorce or separate maintenance, are separated under a written separation agreement, or live apart at all times during the last 6 months of the calendar year; and

(C) Is in the custody of one or both parents for more than one-half of the calendar year.

(ii) *Custodial parent allowed the credit.* A child to whom this paragraph (b)(5) applies is the qualifying individual of only one parent in any taxable year and is the qualifying child of the custodial parent even if the noncustodial parent may claim the dependency exemption for that child for that taxable year. See section 21(e)(5). The custodial parent is the parent having custody for the greater portion of the calendar year. See section 152(e)(4)(A).

(6) *Example.* The provisions of this paragraph (b) are illustrated by the following examples.

Example. C pays $420 for the care of her child, a qualifying individual, to be provided from January 2 through January 31, 2008 (21 days of care). On January 20, 2008, C's child turns 13 years old. Under paragraph (b)(3) of this section, C's child is a qualifying individual from January 2 through January 19, 2008 (13 days of care). C may take into account $260, the pro rata amount C pays for the care of her child for 13 days, under section 21. See §1.21–2(a)(4).

(c) *Gainful employment*—(1) *In general.* Expenses are employment-related expenses only if they are for the purpose of enabling the taxpayer to be gainfully employed. The expenses must be for the care of a qualifying individual or household services performed during periods in which the taxpayer is gainfully employed or is in active search of gainful employment. Employment may consist of service within or outside the taxpayer's home and includes self-employment. An expense is not employment-related merely because it is paid or incurred while the taxpayer is gainfully employed. The purpose of the expense must be to enable the taxpayer to be gainfully employed. Whether the purpose of an expense is to enable the taxpayer to be gainfully employed depends on the facts and circumstances of the particular case. Work as a volunteer or for a nominal consideration is not gainful employment.

(2) *Determination of period of employment on a daily basis*—(i) *In general.* Expenses paid for a period during only part of which the taxpayer is gainfully employed or in active search of gainful employment must be allocated on a daily basis.

(ii) *Exception for short, temporary absences.* A taxpayer who is gainfully employed is not required to allocate expenses during a short, temporary absence from work, such as for vacation or minor illness, provided that the care-giving arrangement requires the taxpayer to pay for care during the absence. An absence of 2 consecutive calendar weeks is a short, temporary absence. Whether an absence longer than 2 consecutive calendar weeks is a short, temporary absence is determined based on all the facts and circumstances.

(iii) *Part-time employment.* A taxpayer who is employed part-time generally must allocate expenses for dependent care between days worked and days not worked. However, if a taxpayer employed part-time is required to pay for dependent care on a periodic basis (such as weekly or monthly) that includes both days worked and days not worked, the taxpayer is not required to allocate the expenses. A day on which the taxpayer works at least 1 hour is a day of work.

(3) *Examples.* The provisions of this paragraph (c) are illustrated by the following examples:

Example 1. D works during the day and her husband, E, works at night and sleeps during the day. D and E pay for care for a qualifying individual during the hours when D is working and E is sleeping. Under paragraph (c)(1) of this section, the amount paid by D and E for care may be for the purpose of allowing D and E to be gainfully employed and may be an employment-related expense under section 21.

Example 2. F works at night and pays for care for a qualifying individual during the hours when F is working. Under paragraph (c)(1) of this section, the amount paid by F for care may be for the purpose of allowing F to be gainfully employed and may be an employment-related expense under section 21.

Example 3. G, the custodial parent of two children who are qualifying individuals, hires a housekeeper for a monthly salary to care for the children while G is gainfully employed. G becomes ill and as a result is absent from work for 4 months. G continues to pay the housekeeper to care for the children while G is absent from work. During this 4-month period, G performs no employment services, but receives payments under her employer's wage continuation plan. Although G may be considered to be gainfully employed during her absence from work, the absence is not a short, temporary absence within the meaning of paragraph (c)(2)(ii) of this section, and her payments for household and dependent care services during the period of illness are not for the purpose of enabling her to be gainfully employed. G's expenses are not employment-related expenses, and she may not take the expenses into account under section 21.

Example 4. To be gainfully employed, H sends his child to a dependent care center that complies with all state and local requirements. The dependent care center requires payment for days when a child is absent from the center. H takes 8 days off from work as vacation days. Because the absence is less than 2 consecutive calendar weeks, under paragraph (c)(2)(ii) of this section, H's absence is a short, temporary absence. H is not required to allocate expenses between days worked and days not worked. The entire fee for the period that includes the 8 vacation days may be an employment-related expense under section 21.

Example 5. J works 3 days per week and her child attends a dependent care center (that complies with all state and local requirements) to enable her to be gainfully employed. The dependent care center allows payment for any 3 days per week for $150 or 5 days per week for $250. J enrolls her child for 5 days per week, and her child attends the care center for 5 days per week. Under paragraph (c)(2)(iii) of this section, J must allocate her expenses for dependent care between days worked and days not worked. Three-fifths of the $250, or $150 per week, may be an employment-related expense under section 21.

Example 6. The facts are the same as in *Example 5,* except that the dependent care center does not offer a 3-day option. The entire $250 weekly fee may be an employment-related expense under section 21.

(d) *Care of qualifying individual and household services*—(1) *In general.* To qualify for the dependent care credit, expenses must be for the care of a qualifying individual. Expenses are for the care of a qualifying individual if the primary function is to assure the individual's well-being and protection. Not all expenses relating to a qualifying individual are for the individual's care. Amounts paid for food, lodging, clothing, or education are not for the care of a qualifying individual. If, however, the care is provided in such a manner that the expenses cover other goods or services that are incidental to and inseparably a part of the care, the full amount is for care.

(2) *Allocation of expenses.* If an expense is partly for household services or for the care of a qualifying individual and partly for other goods or services, a reasonable allocation must be made. Only so much of the expense that is allocable to the household services or care of a qualifying individual is an employment-related expense. An allocation must be made if a housekeeper or other domestic employee performs household duties and cares for the qualifying children of the taxpayer and also performs other services for the taxpayer. No allocation is required, however, if the expense for the other purpose is minimal or insignificant or if an expense is partly attributable to the care of a qualifying individual and partly to household services.

(3) *Household services.* Expenses for household services may be employment-related expenses if the services are performed in connection with the care of a qualifying individual. The household services must be the performance in and about the taxpayer's home of ordinary and usual services necessary to the maintenance of the household and attributable to the care of the qualifying individual. Services of a housekeeper are household services within the meaning of this paragraph (d)(3) if the services are provided, at least in part, to the qualifying individual. Such services as are performed by chauffeurs, bartenders, or gardeners are not household services.

(4) *Manner of providing care.* The manner of providing care need not be the least expensive alternative available to

the taxpayer. The cost of a paid caregiver may be an expense for the care of a qualifying individual even if another caregiver is available at no cost.

(5) *School or similar program.* Expenses for a child in nursery school, preschool, or similar programs for children below the level of kindergarten are for the care of a qualifying individual and may be employment-related expenses. Expenses for a child in kindergarten or a higher grade are not for the care of a qualifying individual. However, expenses for before- or afterschool care of a child in kindergarten or a higher grade may be for the care of a qualifying individual.

(6) *Overnight camps.* Expenses for overnight camps are not employment-related expenses.

(7) *Day camps.* (i) The cost of a day camp or similar program may be for the care of a qualifying individual and an employment-related expense, without allocation under paragraph (d)(2) of this section, even if the day camp specializes in a particular activity. Summer school and tutoring programs are not for the care of a qualifying individual and the costs are not employment-related expenses.

(ii) A day camp that meets the definition of *dependent care center* in section 21(b)(2)(D) and paragraph (e)(2) of this section must comply with the requirements of section 21(b)(2)(C) and paragraph (e)(2) of this section.

(8) *Transportation.* The cost of transportation by a dependent care provider of a qualifying individual to or from a place where care of that qualifying individual is provided may be for the care of the qualifying individual. The cost of transportation not provided by a dependent care provider is not for the care of the qualifying individual.

(9) *Employment taxes.* Taxes under sections 3111 (relating to the Federal Insurance Contributions Act) and 3301 (relating to the Federal Unemployment Tax Act) and similar state payroll taxes are employment-related expenses if paid in respect of wages that are employment-related expenses.

(10) *Room and board.* The additional cost of providing room and board for a caregiver over usual household expenditures may be an employment-related expense.

(11) *Indirect expenses.* Expenses that relate to, but are not directly for, the care of a qualifying individual, such as application fees, agency fees, and deposits, may be for the care of a qualifying individual and may be employment-related expenses if the taxpayer is required to pay the expenses to obtain the related care. However, forfeited deposits and other payments are not for the care of a qualifying individual if care is not provided.

(12) *Examples.* The provisions of this paragraph (d) are illustrated by the following examples:

Example 1. To be gainfully employed, K sends his 3-year old child to a pre-school. The pre-school provides lunch and snacks. Under paragraph (d)(1) of this section, K is not required to allocate expenses between care and the lunch and snacks, because the lunch and snacks are incidental to and inseparably a part of the care. Therefore, K may treat the full amount paid to the preschool as for the care of his child.

Example 2. L, a member of the armed forces, is ordered to a combat zone. To be able to comply with the orders, L places her 10-year old child in boarding school. The school provides education, meals, and housing to L's child in addition to care. Under paragraph (d)(2) of this section, L must allocate the cost of the boarding school between expenses for care and expenses for education and other services not constituting care. Only the part of the cost of the boarding school that is for the care of L's child is an employment-related expense under section 21.

Example 3. To be gainfully employed, M employs a full-time housekeeper to care for M's two children, aged 9 and 13 years. The housekeeper regularly performs household services of cleaning and cooking and drives M to and from M's place of employment, a trip of 15 minutes each way. Under paragraph (d)(3) of this section, the chauffeur services are not household services. M is not required to allocate a portion of the expense of the housekeeper to the chauffeur services under paragraph (d)(2) of this section, however, because the chauffeur services are minimal and insignificant. Further, no allocation under paragraph (d)(2) of this section is required to determine the portion of the expenses attributable to the care of the 13-year old child (not a qualifying individual) because the household expenses are in part attributable to the care of the 9-year-old child. Accordingly, the entire expense of employing the housekeeper is an employment-related expense. The amount that M may take into account as an employment-related expense under section 21, however, is limited to the amount allowable for one qualifying individual.

Example 4. To be gainfully employed, N sends her 9-year-old child to a summer day camp that offers computer activities and recreational activities such as swimming and arts and crafts. Under paragraph (d)(7)(i) of this section, the full cost of the summer day camp may be for care.

Example 5. To be gainfully employed, O sends her 9-year-old child to a math tutoring program for two hours per day during the summer. Under paragraph (d)(7)(i) of this section, the cost of the tutoring program is not for care.

Example 6. To be gainfully employed, P hires a full-time housekeeper to care for her 8-year old child. In order to accommodate the housekeeper, P moves from a 2-bedroom apartment to a 3-bedroom apartment that otherwise is comparable to the 2-bedroom apartment. Under paragraph (d)(10) of this section, the additional cost to rent the 3-bedroom apartment over the cost of the 2-bedroom apartment and any additional utilities attributable to the housekeeper's residence in the household may be employment-related expenses under section 21.

Example 7. Q pays a fee to an agency to obtain the services of an au pair to care for Q's children, qualifying individuals, to enable Q to be gainfully employed. An au pair from the agency subsequently provides care for Q's children. Under paragraph (d)(11) of this section, the fee may be an employment-related expense.

Example 8. R places a deposit with a preschool to reserve a place for her child. R sends the child to a different pre-school and forfeits the deposit. Under paragraph (d)(11) of this section, the forfeited deposit is not an employment-related expense.

(e) *Services outside the taxpayer's household*—(1) *In general.* The credit is allowable for expenses for services performed outside the taxpayer's household only if the care is for one or more qualifying individuals who are described in this section at—

(i) Paragraph (b)(1)(i) or (b)(2)(i); or

(ii) Paragraph (b)(1)(ii), (b)(2)(ii), (b)(1)(iii), or (b)(2)(iii) and regularly spend at least 8 hours each day in the taxpayer's household.

(2) *Dependent care centers*—(i) *In general.* The credit is allowable for services performed by a dependent care center only if—

(A) The center complies with all applicable laws and regulations, if any, of a state or local government, such as state or local licensing requirements and building and fire code regulations; and

(B) The requirements provided in this paragraph (e) are met.

(ii) *Definition.* The term *dependent care center* means any facility that provides full-time or part-time care for more than six individuals (other than individuals who reside at the facility) on a regular basis during the taxpayer's taxable year, and receives a fee, payment, or grant for providing services for the individuals (regardless of whether the facility is operated for profit). For purposes of the preceding sentence, a facility is presumed to provide full-time or part-time care for six or fewer individuals on a regular basis during the taxpayer's taxable year if the facility has six or fewer individuals (including the taxpayer's qualifying individual) enrolled for full-time or part-time care on the day the qualifying individual is enrolled in the facility (or on the first day of the taxable year the qualifying individual attends the facility if the qualifying individual was enrolled in the facility in the preceding taxable year) unless the Internal Revenue Service demonstrates that the facility provides full-time or part-time care for more than six individuals on a regular basis during the taxpayer's taxable year.

(f) *Reimbursed expenses.* Employment-related expenses for which the taxpayer is reimbursed (for example, under a dependent care assistance program) may not be taken into account for purposes of the credit.

(g) *Principal place of abode.* For purposes of this section, the term *principal place of abode* has the same meaning as in section 152.

(h) *Maintenance of a household*—(1) *In general.* For taxable years beginning before January 1, 2005, the credit is available only to a taxpayer who maintains a household that includes one or more qualifying individuals. A taxpayer maintains a household for the taxable year (or lesser period) only if the taxpayer (and spouse, if applicable) occupies the household and furnishes over one-half of the cost for the taxable year (or lesser period) of maintaining the household. The household must be the principal place of abode for the taxable year of the taxpayer and the qualifying individual or individuals.

(2) *Cost of maintaining a household*. (i) Except as provided in paragraph (h)(2)(ii) of this section, for purposes of this section, the term *cost of maintaining a household* has the same meaning as in §1.2–2(d) without regard to the last sentence thereof.

(ii) The cost of maintaining a household does not include the value of services performed in the household by the taxpayer or by a qualifying individual described in paragraph (b) of this section or any expense paid or reimbursed by another person.

(3) *Monthly proration of annual costs*. In determining the cost of maintaining a household for a period of less than a taxable year, the cost for the entire taxable year must be prorated on the basis of the number of calendar months within that period. A period of less than a calendar month is treated as a full calendar month.

(4) *Two or more families*. If two or more families occupy living quarters in common, each of the families is treated as maintaining a separate household. A taxpayer is maintaining a household if the taxpayer provides more than one-half of the cost of maintaining the separate household. For example, if two unrelated taxpayers with their respective children occupy living quarters in common and each taxpayer pays more than one-half of the household costs for each respective family, each taxpayer is treated as maintaining a household.

(i) Reserved.

(j) *Expenses qualifying as medical expenses*—(1) *In general*. A taxpayer may not take an amount into account as both an employment-related expense under section 21 and an expense for medical care under section 213.

(2) *Examples*. The provisions of this paragraph (j) are illustrated by the following examples:

Example 1. S has $6,500 of employment-related expenses for the care of his child who is physically incapable of self-care. The expenses are for services performed in S's household that also qualify as expenses for medical care under section 213. Of the total expenses, S may take into account $3,000 under section 21. S may deduct the balance of the expenses, or $3,500, as expenses for medical care under section 213 to the extent the expenses exceed 7.5 percent of S's adjusted gross income.

Example 2. The facts are the same as in *Example 1*, however, S first takes into account the $6,500 of expenses under section 213. S deducts $500 as an expense for medical care, which is the amount by which the expenses exceed 7.5 percent of his adjusted gross income. S may not take into account the $6,000 balance as employment-related expenses under section 21, because he has taken the full amount of the expenses into account in computing the amount deductible under section 213.

(k) *Substantiation*. A taxpayer claiming a credit for employment-related expenses must maintain adequate records or other sufficient evidence to substantiate the expenses in accordance with section 6001 and the regulations thereunder.

(l) *Effective/applicability date*. This section and §§1.21–2 through 1.21–4 apply to taxable years ending after August 14, 2007.

[T.D. 9354, 72 FR 45341, Aug. 14, 2007]

§ 1.21–2 Limitations on amount creditable.

(a) *Annual dollar limitation*. (1) The amount of employment-related expenses that may be taken into account under §1.21–1(a) for any taxable year cannot exceed—

(i) $2,400 ($3,000 for taxable years beginning after December 31, 2002, and before January 1, 2011) if there is one qualifying individual with respect to the taxpayer at any time during the taxable year; or

(ii) $4,800 ($6,000 for taxable years beginning after December 31, 2002, and before January 1, 2011) if there are two or more qualifying individuals with respect to the taxpayer at any time during the taxable year.

(2) The amount determined under paragraph (a)(1) of this section is reduced by the aggregate amount excludable from gross income under section 129 for the taxable year.

(3) A taxpayer may take into account the total amount of employment-related expenses that do not exceed the annual dollar limitation although the amount of employment-related expenses attributable to one qualifying individual is disproportionate to the total employment-related expenses. For example, a taxpayer with expenses

in 2007 of $4,000 for one qualifying individual and $1,500 for a second qualifying individual may take into account the full $5,500.

(4) A taxpayer is not required to prorate the annual dollar limitation if a qualifying individual ceases to qualify (for example, by turning age 13) during the taxable year. However, the taxpayer may take into account only amounts that qualify as employment-related expenses before the disqualifying event. See also §1.21–1(b)(6).

(b) *Earned income limitation*—(1) *In general*. The amount of employment-related expenses that may be taken into account under section 21 for any taxable year cannot exceed—

(i) For a taxpayer who is not married at the close of the taxable year, the taxpayer's earned income for the taxable year; or

(ii) For a taxpayer who is married at the close of the taxable year, the lesser of the taxpayer's earned income or the earned income of the taxpayer's spouse for the taxable year.

(2) *Determination of spouse*. For purposes of this paragraph (b), a taxpayer must take into account only the earned income of a spouse to whom the taxpayer is married at the close of the taxable year. The spouse's earned income for the entire taxable year is taken into account, however, even though the taxpayer and the spouse were married for only part of the taxable year. The taxpayer is not required to take into account the earned income of a spouse who died or was divorced or separated from the taxpayer during the taxable year. See §1.21–3(b) for rules providing that certain married taxpayers legally separated or living apart are treated as not married.

(3) *Definition of earned income*. For purposes of this section, the term *earned income* has the same meaning as in section 32(c)(2) and the regulations thereunder.

(4) *Attribution of earned income to student or incapacitated spouse*. (i) For purposes of this section, a spouse is deemed, for each month during which the spouse is a full-time student or is a qualifying individual described in §1.21–1(b)(1)(iii) or (b)(2)(iii), to be gainfully employed and to have earned income of not less than—

(A) $200 ($250 for taxable years beginning after December 31, 2002, and before January 1, 2011) if there is one qualifying individual with respect to the taxpayer at any time during the taxable year; or

(B) $400 ($500 for taxable years beginning after December 31, 2002, and before January 1, 2011) if there are two or more qualifying individuals with respect to the taxpayer at any time during the taxable year.

(ii) For purposes of this paragraph (b)(4), a full-time student is an individual who, during each of 5 calendar months of the taxpayer's taxable year, is enrolled as a student for the number of course hours considered to be a full-time course of study at an educational organization as defined in section 170(b)(1)(A)(ii). The enrollment for 5 calendar months need not be consecutive.

(iii) Earned income may be attributed under this paragraph (b)(4), in the case of any husband and wife, to only one spouse in any month.

(c) *Examples*. The provisions of this section are illustrated by the following examples:

Example 1. In 2007, T, who is married to U, pays employment-related expenses of $5,000 for the care of one qualifying individual. T's earned income for the taxable year is $40,000 and her husband's earned income is $2,000. T did not exclude any dependent care assistance under section 129. Under paragraph (b)(1) of this section, T may take into account under section 21 only the amount of employment-related expenses that does not exceed the lesser of her earned income or the earned income of U, or $2,000.

Example 2. The facts are the same as in *Example 1* except that U is a full-time student at an educational organization within the meaning of section 170(b)(1)(A)(ii) for 9 months of the taxable year and has no earned income. Under paragraph (b)(4) of this section, U is deemed to have earned income of $2,250. T may take into account $2,250 of employment-related expenses under section 21.

Example 3. For all of 2007, V is a full-time student and W, V's husband, is an individual who is incapable of self-care (as defined in §1.21–1(b)(1)(iii)). V and W have no earned income and pay expenses of $5,000 for W's care. Under paragraph (b)(4) of this section, either V or W may be deemed to have $3,000 of earned income. However, earned income may be attributed to only one spouse under paragraph (b)(4)(iii) of this section. Under the limitation in paragraph (b)(1)(ii) of this section, the lesser of V's and W's earned income is zero. V and W may not take the expenses into account under section 21.

(d) *Cross-reference.* For an additional limitation on the credit under section 21, see section 26.

[T.D. 9354, 72 FR 45341, Aug. 14, 2007]

§ 1.21–3 Special rules applicable to married taxpayers.

(a) *Joint return requirement.* No credit is allowed under section 21 for taxpayers who are married (within the meaning of section 7703 and the regulations thereunder) at the close of the taxable year unless the taxpayer and spouse file a joint return for the taxable year. See section 6013 and the regulations thereunder relating to joint returns of income tax by husband and wife.

(b) *Taxpayers treated as not married.* The requirements of paragraph (a) of this section do not apply to a taxpayer who is legally separated under a decree of divorce or separate maintenance or who is treated as not married under section 7703(b) and the regulations thereunder (relating to certain married taxpayers living apart). A taxpayer who is treated as not married under this paragraph (b) is not required to take into account the earned income of the taxpayer's spouse for purposes of applying the earned income limitation on the amount of employment-related expenses under § 1.21–2(b).

(c) *Death of married taxpayer.* If a married taxpayer dies during the taxable year and the survivor may make a joint return with respect to the deceased spouse under section 6013(a)(3), the credit is allowed for the year only if a joint return is made. If, however, the surviving spouse remarries before the end of the taxable year in which the deceased spouse dies, a credit may be allowed on the decedent spouse(s separate return.

[T.D. 9354, 72 FR 45341, Aug. 14, 2007]

§ 1.21–4 Payments to certain related individuals.

(a) *In general.* A credit is not allowed under section 21 for any amount paid by the taxpayer to an individual—

(1) For whom a deduction under section 151(c) (relating to deductions for personal exemptions for dependents) is allowable either to the taxpayer or the taxpayer's spouse for the taxable year;

(2) Who is a child of the taxpayer (within the meaning of section 152(f)(1) for taxable years beginning after December 31, 2004, and section 151(c)(3) for taxable years beginning before January 1, 2005) and is under age 19 at the close of the taxable year;

(3) Who is the spouse of the taxpayer at any time during the taxable year; or

(4) Who is the parent of the taxpayer's child who is a qualifying individual described in § 1.21–1(b)(1)(i) or (b)(2)(i).

(b) *Payments to partnerships or other entities.* In general, paragraph (a) of this section does not apply to services performed by partnerships or other entities. If, however, the partnership or other entity is established or maintained primarily to avoid the application of paragraph (a) of this section to permit the taxpayer to claim the credit, for purposes of section 21, the payments of employment-related expenses are treated as made directly to each partner or owner in proportion to that partner's or owner's ownership interest. Whether a partnership or other entity is established or maintained to avoid the application of paragraph (a) of this section is determined based on the facts and circumstances, including whether the partnership or other entity is established for the primary purpose of caring for the taxpayer's qualifying individual or providing household services to the taxpayer.

(c) *Examples.* The provisions of this section are illustrated by the following examples:

Example 1. During 2007, X pays $5,000 to her mother for the care of X's 5-year old child who is a qualifying individual. The expenses otherwise qualify as employment-related expenses. X's mother is not her dependent. X may take into account under section 21 the amounts paid to her mother for the care of X's child.

Example 2. Y is divorced and has custody of his 5-year old child, who is a qualifying individual. Y pays $6,000 during 2007 to Z, who is his ex-wife and the child's mother, for the care of the child. The expenses otherwise qualify as employment-related expenses. Under paragraph (a)(4) of this section, Y may not take into account under section 21 the amounts paid to Z because Z is the child's mother.

Example 3. The facts are the same as in Example 2, except that Z is not the mother of Y's child. Y may take into account under section 21 the amounts paid to Z.

[T.D. 9354, 72 FR 45341, Aug. 14, 2007]

§ 1.23–1 Residential energy credit.

(a) *General rule.* Section 23 or former section 44C provides a residential energy credit against the tax imposed by chapter 1 of the Internal Revenue Code. The credit is an amount equal to the individual's qualified energy conservation expenditures (set out in paragraph (b)) plus the individual's qualified renewable energy source expenditures (set out in paragraph (c)) for the taxable year. However, the credit is subject to the limitations described in paragraph (d) and the special rules contained in §1.23–3. The credit is nonrefundable (that is, the credit may not exceed an individual's tax liability for the taxable year). However, any unused credit may be carried over to succeeding years to the extent permitted under paragraph (e). Renters as well as owners of a dwelling unit may qualify for the credit. See §1.23–3(h) for the rules relating to the allocation of the credit in the case of joint occupants of a dwelling unit.

(b) *Qualified energy conservation expenditures.* In the case of any dwelling unit, the qualified energy conservation expenditures are 15 percent of the energy conservation expenditures made by the taxpayer with respect to the dwelling unit during the taxable year, but not in excess of $2,000 of such expenditures. See §1.23–2(a) for the definition of energy conservation expenditures.

(c) *Qualified renewable energy source expenditures.* In the case of taxable years beginning after December 31, 1979, the qualified renewable energy source expenditures are 40 percent of the renewable energy source expenditures made by the taxpayer during the taxable year (and before January 1, 1986) with respect to the dwelling units that do not exceed $10,000. In the case of taxable years beginning before January 1, 1980, the qualified renewable energy source expenditures are the renewable energy source expenditures made by the taxpayer with respect to the dwelling unit during the taxable year, but not in excess of—

(1) 30 percent of the expenditures up to $2,000, plus

(2) 20 percent of the expenditures over $2,000, but not more than $10,000.

See §1.23–2(b) for the definition of renewable energy source expenditures.

(d) *Limitations*—(1) *Minimum dollar amount.* No residential energy credit shall be allowed with respect to any return (whether joint or separate) for any taxable year if the amount of the credit otherwise allowable (determined without regard to the tax liability limitation imposed by paragraph (d)(3) of this section) is less than $10.

(2) *Prior expenditures taken into account*—(i) *In general.* For purposes of determining the credit for expenditures made during a taxable year, the taxpayer must reduce the maximum amount of allowable expenditures with respect to the dwelling until in computing qualified energy conservation expenditures (under paragraph (b)) or qualified renewable energy conservation expenditures (under paragraph (c)) by prior expenditures which were made by the taxpayer or by joint occupants (see §1.23–3(h)) with respect to the same dwelling unit, and which were taken into account in computing the credit for prior taxable years. In the case of expenditures made during taxable years beginning before January 1, 1980, the reduction of the maximum amount under paragraph (c) must first be made with respect to the first $2,000 of expenditures (to which a 30 percent rate applies) and then with respect to the next $8,000 of expenditures (to which a 20 percent rate applies). This reduction must be made if all or any part of the credit was allowed in or was carried over from a prior taxable year.

(ii) *Change of principal residence.* A taxpayer is eligible for the maximum credit for qualifying expenditures made with respect to a new principal residence notwithstanding the allowance of a credit for qualifying expenditures made with respect to the taxpayer's previous principal residence. Furthermore, except in certain cases involving joint occupancy (see §1.23–3(h)), a taxpayer is eligible for the maximum credit notwithstanding the allowance of a credit to a prior owner of the taxpayer's new principal residence.

(iii) *Example.* The rules with respect to the reduction for prior expenditures are illustrated by the following example:

Example. In 1978, A has $1,000 of energy conservation expenditures and $5,000 of renewable energy source expenditures in connection with A's principal residence. A's residential energy credit for 1978 is $1,350, made up of $150 of qualified energy conservation expenditures (15 percent of $1,000) plus $1,200 of qualified renewable energy source expenditures (30 percent of the first $2,000 plus 20 percent of the next $3,000). In 1979 A has an additional $2,000 of energy conservation expenditures and $3,000 of renewable energy source expenditures in connection with the same principal residence. A's residential energy credit for 1979 is $750, made up of $150 of qualified energy conservation expenditures (15 percent of the new maximum $1,000, which was reduced from $2,000 by $1,000 of energy conservation expenditures taken into account in 1978) plus $600 of qualified renewable energy source expenditures (20 percent of $3,000, which reflects the reduction of the maximum allowable expenditures by the $5,000 of renewable energy source expenditures taken into account in 1978). The maximum residential energy credit allowable to A with respect to the same principal residence in subsequent years in which the credit is allowable is $400 (20 percent of the new maximum of $2,000 for renewable energy source expenditures and none for energy conservation expenditures).

(3) *Effects of grants and subsidized energy financing*—(i) *In general.* Qualified expenditures financed with Federal, State, or local grants shall be taken into account for purposes of computing the residential energy credit only if the amount of such grants is taxable as gross income to the taxpayer under section 61 (relating to the definition of gross income) and the regulations thereunder. In the case of taxable years beginning after December 31, 1980, qualified expenditures made from subsidized energy financing (as defined in §1.23–2(i)) shall not be taken into account (except as provided in the following sentence) for purposes of computing the residential energy credit. In addition, the taxpayer must reduce the maximum amount allowable expenditures (reduced as provided in paragraph (d)(2) of this section) with respect to the dwelling unit in computing qualified energy conservation expenditures (under paragraph (b) of this section) or qualified renewable energy source expenditures (under paragraph (c) of this section), whichever is appropriate, by an amount equal to the sum of—

(A) The amount of expenditures from subsidized energy financing (as defined in §1.23–2(i)) that were made by the taxpayer during the taxable year or any prior taxable year beginning after December 31, 1980, with respect to the same dwelling unit, and

(B) The amount of any funds received by the taxpayer during the taxable year or any prior taxable year beginning after December 31, 1980, as a Federal, State, or local government grant made in taxable years beginning after December 31, 1980, that were used to make qualified expenditures with respect to the same dwelling unit and that were not included in the gross income of the taxpayer.

(ii) *Example.* The provisions of this paragraph (d)(3) may be illustrated by the following example:

Example. A had in 1979 made a renewable energy source expenditure of $2,000 in connection with A's residence for which he took the then allowed credit of $600. In 1981 A made additional renewable energy source expenditures of $9,000 with respect to which he received a loan of $5,000 from the Federal Solar-Energy and Energy Conservation Bank. Assume that the loan is subsidized energy financing. A computes the credit as follows: The initial maximum allowable dollar limit is $10,000 which is reduced by the sum of the prior year expenditures of $2,000 and the subsidized energy financing loan of $5,000 leaving a dollar limit of $3,000 ($10,000 − ($2,000 + $5,000)). The $5,000 portion of the $9,000 funded by the subsidized energy financing loan is not allowed as a renewable energy source expenditure. The remaining expenditures in 1981 are $4,000 ($9,000 − $5,000). However, this amount exceeds the allowed maximum dollar limit of $3,000. Therefore, A's creditable expenses for 1981 are only $3,000 on which the credit is $1,200 (40 percent of $3,000).

(4) *Tax liability limitation*—(i) *For taxable years beginning after December 31, 1983.* For taxable years beginning after December 31, 1983, the credit allowed by this section shall not exceed the amount of tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year, reduced by the sum of credits allowable under—

(A) Section 21 (relating to expenses for household and dependent care services necessary for gainful employment),

(B) Section 22 (relating to credit for the elderly and the permanently and totally disabled), and

(C) Section 24 (relating to contributions to candidates for public office).

See section 26 (b) and (c) for certain taxes that are not treated as imposed by chapter 1.

(ii) *For taxable years beginning before January 1, 1984.* For taxable years beginning before January 1, 1984, the credit allowed by this section shall not exceed the amount of the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year, reduced by the sum of the credits allowable under—

(A) Section 32 (relating to tax withheld at source on nonresident aliens and foreign corporations and on tax-free covenant bonds),

(B) Section 33 (relating to the taxes of foreign countries and possessions of the United States),

(C) Section 37 (relating to retirement income),

(D) Section 38 (relating to investment in certain depreciable property),

(E) Section 40 (relating to expenses of work incentive programs),

(F) Section 41 (relating to contributions to candidates for public office),

(G) Section 42 (relating to the general tax credit),

(H) Section 44 (relating to purchase of new personal residence),

(I) Section 44A (relating to expenses for household and dependent care services), and

(J) Section 44B (relating to employment of certain new employees).

(e) *Carryforward of unused credit.* If the credit allowable by this section exceeds the tax liability limitation imposed by section 23(b)(5) (or former section 44C(b)(5)) and paragraph (d)(4) of this section, the excess credit shall be carried forward to the succeeding taxable year and added to the credit allowable under this section for the succeeding taxable year. A carryforward that is not used in the succeeding year because it exceeds the tax liability limitation shall be carried forward to later taxable years until used, except that no excess credit may be carried forward to any taxable year beginning after December 31, 1987.

[T.D. 7717, 45 FR 57715, Aug. 29, 1980. Redesignated and amended by T.D. 8146, 52 FR 26669, July 16, 1987]

§ 1.23–2 Definitions.

For purposes of section 23 or former section 44C and regulations thereunder—

(a) *Energy conservation expenditures*—(1) *In general.* The term ''energy conservation expenditure'' means an expenditure made on or after April 20, 1977, and before January 1, 1986, by a taxpayer for insulation or any other energy-conserving component, or for labor costs allocable to the original installation of such insulation or other component, if all of the following conditions are satisfied:

(i) The insulation (as defined in paragraph (c)) or other energy-conserving component (as defined in paragraph (d)) is installed in or on a dwelling unit that is used as the taxpayer's principal residence when the installation is completed. See §1.23–3(e) for the definition of principal residence.

(ii) The dwelling unit is located in the United States (as defined in section 7701(a)(9)).

(iii) The construction of the dwelling unit was substantially completed before April 20, 1977. See §1.23–3(f) for the definition of the terms ''construction'' and ''substantially completed''. In the case of expenditures made with respect to the enlargement of a dwelling unit, the construction of the enlargement must have been substantially completed before April 20, 1977.

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

Example 1. In 1978, A spent $500 for the purchase and installation of new storm windows to replace old storm windows, $100 to reinstall old storm windows, and $150 to transfer a A's house insulation which had been installed in A's garage. Only the $500 spent for new storm windows qualifies as an energy conservation expenditure. The $100 spent to reinstall storm windows and the $150 spent to transfer insulation to A's house do not qualify since the only installation costs that qualify are those for the original installation of energy conservation property the original use of which commences with the taxpayer.

Example 2. In June 1977, B purchased for B's principal residence a new house that was substantially completed before April 20, 1977. Pursuant to B's request the builder installed storm windows on May 1, 1977, the cost of this option being included in the purchase price of the house. The portion of the purchase price of the residence allocable to the storm windows constitutes an energy conservation expenditure. However, no other part of the purchase price may be allocated to energy conservation property (insulation and other energy conserving components) installed before April 20, 1977. To qualify as an energy conservation expenditure, an expenditure must be made (*i.e.*, installation of the energy conservation property must be completed) on or after April 20, 1977.

(b) *Renewable energy source expenditures.* The term ''renewable energy source expenditures'' means an expenditure made on or after April 20, 1977, and before January 1, 1986, by a taxpayer for renewable energy source property (as defined in paragraph (e)), or for labor costs properly allocable to the on-site preparation, assembly, or original installation such property, if both of the following conditions are satisfied:

(1) The renewable energy source property is installed in connection with a dwelling unit that is used as the taxpayer's principal residence when the installation is completed. See §1.23–3(e).

(2) The dwelling unit is located in the United States (as defined in section 7701(a)(9)).

Additionally, the term ''renewable energy source expenditures'' includes expenditures made after December 31, 1979, and before January 1, 1986, for an onsite well drilled for any geothermal deposit (as defined in paragraph (h)), or for labor costs properly allocable to onsite preparation, assembly, or original installation of such well, but only if the requirements of paragraphs (b) (1) and (2) of this section are met and the taxpayer has not elected under section 263(c) to deduct any portion of such expenditures or allocable labor costs.

Eligibility as a renewable energy source expenditure does not depend on the date of construction of the dwelling unit. Thus, such an expenditure may be made in connection with either a new or an existing dwelling unit. Renewable energy source expenditures need only be made in connection with a dwelling, rather than in or on a dwelling unit. For example, a solar collector that otherwise constitutes renewable energy source property is not ineligible merely because it is installed separately from the dwelling unit. The term ''renewable energy source expenditure'' does not include any expenditure allocable to a swimming pool even when used as an energy storage medium or to any other energy storage medium whose primary function is other than the storage of energy. It also does not include the cost of maintenance of an installed system or the cost of leasing renewable energy source property.

(c) *Insulation.* The term ''insulation'' means any item that satisfies all of the following conditions:

(1) The item is specifically and primarily designed to reduce, when installed in or on a dwelling or on a water heater, the heat loss or gain of such dwelling or water heater. To qualify as insulation the item must be installed between a conditioned area and a nonconditioned area (except when installed on a water heater, water pipe, or heating/cooling duct). Thus for example, awnings do not qualify as insulation. For purposes of this section the term ''conditioned area'' means an area that has been heated or cooled by conventional or renewable energy source means. Insulation includes materials made of fiberglass, rock wool, cellulose, urea based foam, urethane, vermiculite, perlite, polystyrene, and extruded polystyrene foam.

(2) The original use of the item begins with the taxpayer.

(3) The item can reasonably be expected to remain in operation at least 3 years.

(4) The item meets the applicable performance and quality standards prescribed in §1.23–4 (if any) that are in effect at the time the taxpayer acquires the item. The term ''insulation'' shall not include items whose primary purpose is not insulation (e.g., whose function is primarily structural, decorative, or safety-related). For example, carpeting, drapes (including linings), shades, wood paneling, fireplace screens (including those made of glass), new or replacement walls (except for

qualifying insulation therein) and exterior siding do not qualify although they may have been designed in part to have an insulating effect.

(d) *Other energy-conserving components.* The term ''other energy-conserving component'' means any item (other than insulation) that satisfies all of the following conditions:

(1) The original use of the item begins with the taxpayer.

(2) The item can reasonably be expected to remain in operation for at least 3 years.

(3) The item meets the applicable performance and quality standards prescribed in §1.23–4 (if any) that are in effect at the time of the taxpayer's acquisition of the item.

(4) The item is one of the following items:

(i) *A furnace replacement burner.* The term ''furnace replacement burner'' means a device (for oil and gas-fired furnaces or boilers) that is designed to achieve a reduction in the amount of fuel consumed as a result of increased combustion efficiency. The burner must replace an existing burner. It does not qualify if it is acquired as a component of, or for use in, a new furnace or boiler.

(ii) *A device for modifying flue openings.* The term ''device for modifying flue openings'' means an automatically operated damper that—

(A) Is designed for installation in the flue, between the barometric damper or draft hood and the chimney, of a furnace; and

(B) Conserves energy by substantially reducing the flow of conditioned air through the chimney when the furnace is not in operation. Conditioned air is air that has been heated or cooled by conventional or renewable energy source means.

(iii) *A furnace ignition system.* The term ''furnace ignition system'' means an electrical or mechanical device, designed for installation in a gas-fired furnace or boiler that automatically ignites the gas burner. In order to qualify, the device must replace a gas pilot light. Furthermore, it does not qualify if it is acquired as a component of, or for use in, a new furnace or boiler.

(iv) *A storm or thermal window or door.* The terms ''storm or thermal window'' and ''storm or thermal door'' mean the following:

(A)(*1*) A window placed outside or inside an ordinary or prime window, creating an insulating air space.

(*2*) A window with enhanced resistance to heat flow through the glazed area by multi-glazing.

(*3*) A window that consists of glass or other glazing materials that have exceptional heat-absorbing or heat-reflecting properties. For purposes of this subdivision (iv), the term ''glazing material'' does not include films and coatings applied on the surface of a window.

(B)(*1*) A second door, installed outside or inside a prime exterior door, creating an insulating air space.

(*2*) A door with enhanced resistance to heat flow through the glazed area by multi-glazing.

(*3*) A prime exterior door that has an R-value (a measurement of the ability of insulation to resist the flow of heat) of at least 2 throughout.

For purposes of this subdivision, ''multi-glazing'' is an arrangement in which two or more sheets of glazing material are affixed in a window or door frame to create one or more insulating air spaces. Multi-glazing can be achieved by installing a preassembled, sealed insulating glass unit or by affixing one or more additional sheets of glazing onto an existing window (or sash) or door. For purposes of this subdivision, a storm or thermal window or door does not include any film applied on or over the surface of a window or door.

(v) *Automatic energy-saving setback thermostat.* The term ''automatic energy-saving setback thermostat'' means a device that is designed to reduce energy consumption by regulating the demand on the heating or cooling system in which it is installed, and uses—

(A) A temperature control device for interior spaces incorporating more than one temperature control level, and

(B) A clock or other automatic mechanism for switching from one control level to another.

(vi) *Caulking and weatherstripping.* The term ''caulking'' means pliable materials used to fill small gaps at fixed joints on buildings to reduce the passage of air and moisture. Caulking includes, but is not limited to, materials commonly known as ‘‘sealants’’, ‘‘putty’’, and ‘‘glazing compounds’’. The term ‘‘weatherstripping’’ means narrow strips of material placed over or in movable joints of windows and doors to reduce the passage of air and moisture.

(vii) *Energy usage display meter*. The term ‘‘energy usage display meter’’ means a device the sole purpose of which is to display the cost (in money) of energy usage in the dwelling. It may show cost information for electricity usage, gas usage, oil usage, or any combination thereof. The device may measure energy usage of the whole dwelling, or individual appliances or systems on an instantaneous or cumulative basis.

(viii) *Components specified by the Secretary*. The Secretary (or his delegate) may, in his discretion, after consultation with the Secretary of Energy and the Secretary of Housing and Urban Development (or their delegates), and any other appropriate Federal officers, specify by regulation other energy-conserving components for addition to the list of qualified items. See §1.23–6 for the procedures and criteria to be used in determining whether an item will be considered for addition to the list of qualified items by the Secretary.

The term ‘‘other energy-conserving component’’ is limited to items in a category specifically listed in section 44(c)(4)(A) (i) through (vii) or added by the Secretary.

(e) *Renewable energy source property*—(1) *In general*. The term ‘‘renewable energy source property’’ includes any solar energy property, wind energy property, geothermal energy property, or property referred to in subparagraph (2), which meets the following conditions:

(i) The original use of the property begins with the taxpayer.

(ii) The property can reasonably be expected to remain in operation for at least 5 years.

(iii) The property meets the applicable performance and quality standards prescribed in §1.23–4 (if any) that are in effect at the time of the taxpayer's acquisition of the property.

Renewable energy source property does not include heating or cooling systems, nor systems to provide hot water or electricity, which serve to supplement renewable energy source equipment in heating, cooling, or providing hot water or electricity to a dwelling unit, and which employ a form of energy (such as oil or gas) other than solar, wind, or geothermal energy (or other forms of renewable energy provided in paragraph (e)(2) of this section. Thus, heat pumps or oil or gas furnaces, used in connection with renewable energy source property, are not eligible for the credit. In order to be eligible for the credit for renewable energy source property, the property (as well as labor costs properly allocable to onsite preparation, assembly or installation of equipment) must be clearly identifiable. See §1.23–3(l) for recordkeeping rules.

(2) *Renewable energy source specified by the Secretary*. In addition to solar, wind, and geothermal energy property, renewable energy source property includes property that transmits or uses another renewable energy source that the Secretary (or his delegate) specifies by regulations, after consultation with the Secretary of Energy and the Secretary of Housing and Urban Development (or their delegates), and any other appropriate Federal officers, to be of a kind that is appropriate for the purpose of heating or cooling the dwelling or providing hot water or (in the case of expenditures made after December 31, 1979) electricity for use within the dwelling. For purposes of this section, references to the transmission or use of energy include its collection and storage. See §1.23–6 for the procedures and criteria to be used in determining when another energy source will be considered for addition to the list of qualified renewable energy sources.

(f) *Solar energy property*—(1) *In general*. The term ‘‘solar energy property’’ means equipment and materials of a solar energy system as defined in this paragraph (and parts solely related to the functioning of such equipment) which, when installed in connection with a dwelling, transmits or uses solar energy to heat or cool the dwelling or to provide hot water or (in the case of expenditures made after December 31,

1979) electricity for use within the dwelling. For this purpose, solar energy is energy derived directly from sunlight (solar radiation). Property which uses, as an energy source, fuel or energy which is indirectly derived from sunlight (solar radiation), such as fossil fuel or wood or heat in underground water, is not considered solar energy property. Materials and components of ''passive solar systems'' as well as ''active solar systems'', or a combination of both types of systems may qualify as solar energy property.

(2) *Active solar system.* An active solar system is based on the use of mechanically forced energy transfer, such as the use of fans or pumps to circulate solar generated energy, or thermal energy transfer, such as systems utilizing thermal siphon principles. Generally, this is accomplished through the use of equipment such as collectors (to absorb sunlight and create hot liquids or air), storage tanks (to store hot liquids), rockbeds (to store hot air), thermostats (to activate pumps or fans which circulate the hot liquids or air), and heat exchangers (to utilize hot liquids or air to heat air or water).

(3) *Passive solar system.* A passive solar system is based on the use of conductive, convective, or radiant energy transfer. In order to qualify as a passive solar system, a solar system used for heating purposes must contain all of the following: a solar collection area, an absorber, a storage mass, a heat distribution method, and heat regulation devices. The term ''solar collection area'' means an expanse of transparent or translucent material, such as glass which is positioned in such a manner that the rays of the sun directly strike an absorber. The term ''absorber'' means a surface, such as a floor, that is exposed to the rays of the sun admitted through the solar collection area, which converts solar radiation into heat, and then transfers the heat to a storage mass. The term ''storage mass'' means material, such as masonry, that receives and holds heat from the absorber and later releases the heat to the interior of the dwelling. The storage mass must be of sufficient volume, depth, and thermal energy capacity to store and deliver adequate amounts of solar heat for the relative size of the dwelling. In addition, the storage mass must be located so that it is capable of distributing the stored heat directly to the habitable areas of the dwelling through a heat distribution method. The term ''heat distribution method'' means the release of radiant heating from the storage mass within the habitable areas of the dwelling, or convective heating from the storage mass through airflow paths provided by openings or by ducts in the storage mass, to habitable areas of the dwelling. The term ''heat regulations devices'' means shading or venting mechanisms (such as awnings or insulated drapes) to control the amount of solar heat admitted through the solar collection areas and nighttime insulation or its equivalent to control the amount of heat permitted to escape from the interior of the dwelling.

(4) *Components with dual function.* To the extent that a passive or active solar system utilizes portions of the structure of a residence, only the materials and components whose sole purpose is to transmit or use solar radiation (and labor costs associated with installing such materials and components) are included within the term ''solar energy property''. Accordingly, materials and components that serve a dual purpose, e.g., they have a significant structural function or are structural components of the dwelling (and labor costs associated with installing such materials and components) are not included within the term ''solar energy property''. For example, roof ponds that form part of a roof (including additional structural components to support the roof), windows (including clerestories and skylights), and greenhouses do not qualify as solar energy property. However, with respect to expenditures made after December 31, 1979, a solar collector panel installed as a roof or portion thereof (including additional structural components to support the roof attributable to the collector) does not fail to qualify as solar energy property solely because it constitutes a structural component of the dwelling on which it is installed. For this purpose, the term ''solar collector panel'' does not include a skylight or other type of window. In the case of a trombe wall (a south facing

wall composed of a mass wall and exterior glazing), the mass wall (and labor costs associated with installing the mass wall) will not qualify. However, the exterior (non-window) glazing will qualify. Any shading, venting and heat distribution mechanisms or storage systems that do not have a dual function will also qualify.

(g) *Wind energy property.* The term ''wind energy property'' means equipment (and parts solely related to the functioning of such equipment) which, when installed in connection with a dwelling, transmits or uses wind energy to produce energy in a useful form for personal residential purposes. Examples of equipment using wind energy to produce energy in a useful form are windmills, wind-driven generators, power conditioning and storage devices that use wind to generate electricity or mechanical forms of energy. Devices that use wind merely to ventilate do not qualify as wind energy property.

(h) *Geothermal energy property.* The term ''geothermal energy property'' means equipment (and parts solely related to the functioning of such equipment) necessary to transmit or use energy from a geothermal deposit to heat or cool a dwelling or provide hot water for use within the dwelling. With respect to expenditures made after December 31, 1979, the term ''geothermal energy property'' also means equipment (and parts solely related to the functioning of such equipment) necessary to transmit or use energy from a geothermal deposit to produce electricity for use within the dwelling. Equipment such as a pipe that serves both a geothermal function (by transmitting hot geothermal water within a dwelling) and a non-geothermal function (by transmitting hot water from a water heater within a dwelling) does not qualify as geothermal property. A geothermal deposit is a geothermal reservoir consisting of natural heat which is from an underground source and is stored in rocks or in an aqueous liquid or vapor (whether or not under pressure), having a temperature exceeding 50 degrees Celsius as measured at the wellhead or, in the case of a natural hot spring (where no well is drilled), at the intake to the distribution system.

(i) *Subsidized energy financing*—(1) *In general.* The term ''subsidized energy financing'' means financing (e.g., a loan) made directly or indirectly (such as in association with, or through the facilities of, a bank or other lender) during a taxable year beginning after December 31, 1980, under a Federal, State, or local program, a principal purpose of which is to provide subsidized financing for projects designed to conserve or produce energy. For purposes of this paragraph (i), financing is made when funds that constitute subsidized energy financing are disbursed. Subsidized energy financing includes financing under a Federal, State, or local program having two or more principal purposes (provided that at least one of the principal purposes is to provide subsidized financing for projects designed to conserve or produce energy), but only to the extent that the financing—

(i) Is to be used for energy production or conservation purposes, or

(ii) Is provided out of funds designated specifically for energy production or conservation.

Loan proceeds meet the use test of paragraph (i)(1)(i) of this section only to the extent that the loan application, the loan instrument, or any other loan-related documents indicate that the funds are intended for such use. However, loan proceeds designated for the purchase either of property that contains ''insulation'' or any ''other energy-conserving component'' or of ''renewable energy source property'' as defined in paragraphs (c), (d), and (e), respectively, of this section meet the test of paragraph (i)(1)(i) of this section. Financing is subsidized if the interest rate or other terms of the financing (including any special tax treatment) provided to the taxpayer in connection with the program or used to raise funds for the program are more favorable than the terms generally available commercially. In addition, financing is subsidized if the principal obligation of the financing provided to the taxpayer is reduced by funds provided under the program. The source from which the funds for the program are derived is not a factor to be taken into account in determining whether the financing is subsidized. If a public utility disburses funds for the financing of energy conservation or renewable energy source property under a program that obtains the funds through sales to the utility's ratepayers, the program is not considered to be a Federal, State or local program even though the utility is a governmental agency, and, thus, the funds are not subsidized energy financing. Subsidized energy financing does not include a grant includible in gross income under section 61, nontaxable grants, a credit against State or local taxes made directly to the taxpayer claiming the credit provided for in section 23, or a loan guarantee made directly to the taxpayer claiming the credit provided for in section 23.

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

Example 1. State A has a farm and home loan program. The program is used to provide low interest mortgage loans. In 1984 State A's legislature enacted statutory amendments to its farm and home loan program in an effort to encourage energy conservation-type measures. Low interest loans for such improvements were made available to qualified purchasers and owners under the farm and home loan program. The energy conservation measures subsidized by the program include energy conserving components and renewable energy source devices. State A's tax exempt bonds are the source of funds for loans under the program. Although the 1984 legislation authorizing loans for energy conserving components and renewable energy source improvements did not diminish the original purpose of the farm and home loan program, the 1984 legislation added another principal purpose to the program. Therefore, State A's program which has two principal purposes, one of which is the conservation or production of energy, is considered as providing subsidized energy financing for purposes of section 23 (c)(10) of the Code, to the extent that financing is provided by State A out of funds designated specifically for energy production or conservation. State A's program will also be considered as providing subsidized energy financing to the extent that the loan proceeds are to be used for energy production or conservation purposes. Loan proceeds meet the use test of the preceding sentence only to the extent that loan application, the loan instruments, or any other loan-related documents indicate that the funds are intended for such use.

Example 2. The United States Department of Energy disburses funds to State B that the Department received from settlements from alleged petroleum pricing and allocation violations. State B establishes a program under which B will use the funds to make loans at below market interest rates directly to qualified applicants for the purchase of renewable energy source property. B's loans are subsidized energy financing.

Example 3. State C establishes a program under which C will make loans at below market interest rates directly to qualified applicants for the purchases of renewable energy source property. The program is funded with money that State C was able to borrow after it obtained a loan guarantee from a Federal agency. C's loans provided under the program are subsidized energy financing.

Example 4. Company D is an electric utility that is a Federal agency. D purchases its electricity from another federal agency, transmits the electricity over its own distribution system, and sells the electricity to numerous local public utilities that in turn sell the electricity to their customers. D wishes to start a program under which D will make loans at below market interest rates directly to customers of the local utilities for the purchase of renewable energy source property from D. The local public utility will act as the collection agent for repayment of the loans. The loans will be repayable over a period of time not in excess of 15 years. Under law, D must cover its full costs through its own revenues derived from the sale of power and other services. While D may borrow by sale of bonds to the United States Treasury, D must borrow at rates comparable to the rates prevailing in the market for similar bonds. Thus, the subsidized loans made under D's program will be financed by the profits from the sale of electricity to consumers and not by the federal government. D's program, which is substantially the same as that carried out by private (investor-owned) utilities, is not considered to be a Federal, State or local governmental program. Therefore, D's loans are not subsidized energy financing.

Example 5. The Solar Energy and Energy Conservation Bank (Bank) disburses funds to State E. E disburses a portion of the funds to Financial Institution F. Both the Bank and State E make these disbursements under a program the principal purpose of which is to provide subsidized financing for projects designed to conserve or produce energy. F uses the funds to reduce a portion of the principal obligation on loans it issues to finance energy conservation or solar energy expenditures. Taxpayer G borrows $3,000 from F in order to purchase a solar water heating system. F uses $500 of the funds it received from the Bank to reduce the principal obligation of the loan to G to $2,500. The amount of subsidized energy financing to G is $3,000.

Example 6. State H allows a tax credit to Financial Institution J under a program the principal purpose of which is to provide loans at below market interest rates directly to qualified applicants for the purchase of renewable energy source property. J receives a credit each year in the amount of the excess of the interest that would have been paid at private market rates over the actual interest paid on such loans. The State H tax credit arrangement is an interest subsidy. Thus, any low-interest loans made pursuant to this credit arrangement are subsidized energy financing.

[T.D. 7717, 45 FR 57716, Aug. 29, 1980. Redesignated and amended by T.D. 8146, 52 FR 26670, July 16, 1987]

§ 1.23–3 Special rules.

(a) *When expenditures are treated as made*—(1) *Timeliness of an expenditure for the energy credit.* In general, for the purpose of determining whether an expenditure qualifies as being timely for the residential energy credit under section 23 or former section 44C (*i.e.*, is made after April 19, 1977, and before January 1, 1986), the expenditure is treated as made when original installation of the item is completed. Thus, solely for that purpose, the time of payment or accrual is irrelevant.

(2) *Special rule for renewable energy source expenditures in the case of construction or reconstruction of a dwelling.* In the case of renewable energy source expenditures in connection with the construction or reconstruction of a dwelling that becomes the taxpayer's new principal residence, the expenditures are to be treated as made (for the purpose of determining the timeliness of an expenditure for the residential energy credit) when the taxpayer commences use of the dwelling as his or her principal residence following its construction or reconstruction. The term ''reconstruction'' means the replacement of most of a dwelling's major structural components such as floors, walls, and ceiling. When a taxpayer reoccupies a reconstructed dwelling that was the taxpayer's principal residence prior to reconstruction, a renewable energy source expenditure is considered made when the original installation of the renewable energy source property is completed.

(3) *Taxable year in which credit is allowable.* For the purpose of determining the taxable year in which the credit for an expenditure is allowable (once it has qualified as timely under subparagraph (1) or (2)), an expenditure is treated as made on the later of (i) the date on which it qualifies as timely; or (ii) the date on which it is paid or incurred by the taxpayer.

(b) *Expenditures in 1977.* No credit under section 23 or former section 44C shall be allowed for any taxable year beginning before 1978. However, the amount of any credit under section 23 or former section 44C for the taxpayer's first taxable year beginning after December 31, 1977, shall take into account qualified energy conservation expenditures and qualified renewable energy source expenditures made during the period beginning April 20, 1977, and ending on the last day of such first taxable year.

(c) *Cross reference.* For rules relating to expenditures financed with Federal, State, or local government grants or subsidized financing see paragraph (d)(3) of § 1.23–1 and paragraph (i) of § 1.23–2.

(d) *Expenditures qualifying both as energy conservation expenditures and renewable source expenditures.* In the case of an expenditure which meets both the definition of an energy conservation expenditure (as defined in § 1.23–2(a)) and a renewable energy source expenditure (as defined in § 1.23–2(b)), the taxpayer may claim either a credit under § 1.23–1(b) (relating to qualified energy conservation expenditures) or § 1.23–1(c) (relating to qualified renewable energy source expenditures) but may not claim both credits with respect to the same expenditure.

(e) *Principal residence.* For purposes of section 23 or former section 44C the determination of whether a dwelling unit is the taxpayer's principal residence shall be made under principles similar to those applicable to section 1034 and the regulations thereunder (relating to sale or exchange of a principal residence) except that ownership of the dwelling unit is not required. In making this determination, the period for which a dwelling is treated as a taxpayer's principal residence includes the 30-day period ending on the first day on which the dwelling unit would (but for this sentence) be treated as being used as the taxpayer's principal residence under principles similar to those applicable to section 1034. Thus, installation that are completed within that 30-day period may be eligible for the credit although, in the absence of the 30-day rule, the date of habitation of the dwelling unit by the taxpayer would mark the beginning of the taxpayer's use of the unit as a principal residence.

(f) *Construction substantially completed*. Construction of a dwelling unit is substantially completed when construction has progressed to the point where the unit could be put to use as a personal residence, even though comparatively minor items remain to be finished or performed in order to conform to the plans or specifications of the completed building. For this purpose, construction includes reconstruction as defined in paragraph (a)(2). This rule may be illustrated by the following example:

Example. On January 1, 1979, A purchases a dwelling that is to become A's principal residence. The dwelling unit was originally constructed in 1950. A spends $50,000 to reconstruct the dwelling by replacing most of the dwelling's major structural components such as floors, walls, and ceilings. Included in the cost is $3,000 attributable to energy-conserving components. Reconstruction is substantially completed on April 1, 1979, and A moves into the reconstructed residence on May 1, 1979. Since construction includes reconstruction, A's reconstructed residence is not considered substantially completed before April 20, 1977. Thus, amounts spent with respect to A's reconstructed residence for energy-conserving components do not qualify as energy conservation expenditures.

(g) *Residential use of property*. To be eligible for the residential energy credit, expenditures must be made for personal residential purposes. If at least 80 percent of the use of a component or item of property is for personal residential purposes, the entire amount of the energy conservation expenditure or the renewable energy source expenditure is taken into account in computing the credit under this section. If less than 80 percent of the use of a component or item of property is for personal residential purposes, the amount of an expenditure taken into account is the amount that bears the same ratio to the amount of the expenditure as the amount of personal residential use of the component or item bears to its total use. For purposes of this paragraph, use of a component or an item of property with respect to a swimming pool is not a use for a personal residential purpose. The rules with respect to residential use of property are illustrated by the following examples:

Example 1. In 1978 A makes an expenditure of $3,000 for the installation of storm windows of which 50 percent is on the portion of A's dwelling used as the principal family residence and 50 percent is on the portion of the dwelling used as an office. A has made no other energy conservation expenditures for the residence. The allowable energy conservation expenditure is $1,500 (50 percent of $3,000), the portion attributable to residential use. Therefore, the residential energy credit is $225 (the qualified conservation expenditure of 15 percent of $1.500).

Example 2. During 1979, B makes $10,000 of renewable energy source expenditures on solar energy property for B's principal residence. Approximately 60 percent of the use of the solar energy property will be for heating B's swimming pool; the other 40 percent will be for heating the dwelling unit. B had not previously made renewable energy source expenditures with respect to the residence. Since use for a swimming pool is not considered a residential use, less than 80 percent of the use of B's solar energy property is considered used for personal residential purposes. Therefore, only $4,000 (40 percent of $10,000), the proportionate part of B's expenditures representing personal residential use, is treated as a renewable energy source expenditure. B is allowed a $1,000 residential energy credit (30 percent of $2,000 plus 20 percent of $2,000) for 1979.

(h) *Joint occupancy*—(1) *In general*. If two or more individuals jointly occupied and used a dwelling unit as their principal residence during any portion of a calendar year—

(i) The amount of the credit allowable under section 23 or former section 44C by reason of energy conservation expenditures or by reason of renewable energy source expenditures shall be determined by treating all of the joint occupants as one taxpayer whose taxable year is such calendar year; and

(ii) The credit under section 23 or former section 44C allowable to each joint occupant for the taxable year with which or in which such calendar year ends shall be an amount which bears the same ratio to the amount determined under paragraph (h)(1)(i) of this section as the amount of energy conservation expenditures or renewable energy source expenditures made by that occupant bears to the total amount of each type of such expenditures made by all joint occupants during such calendar year.

The provisions of this subparagraph may be illustrated by the following example:

Example. A, a calendar year taxpayer, and B, a June 1 fiscal year taxpayer, make energy conservation exenditures of $2,000 (A making expenditures of $500 and B making expenditures of $1,500) on their principal and jointly occupied residence in 1978. A and B have not previously make energy conservation expenditures with respect to this residence. Of the $300 credit (15 percent of $2,000), $75 will be allocated to A ($500 / $2,000 × $300) and $225 to B ($1,500 / $2,000 × 300). A will claim the allocable share of the credit on A's 1978 tax return and B will claim the allocable share of the credit on B's tax return for the fiscal year ending May 31, 1979.

(2) *Minimum credit.* The fact that one joint occupant may be unable to claim all or part of the credit under section 23 of former section 44C because of insufficient tax liability or because that occupant's allowable credit does not exceed the $10 minimum credit (as set forth in paragraph (d)(1) of § 1.23–1) shall have no effect upon the computation of the amount of the allowable credits for the other joint occupants.

(3) *Prior expenditures.* Because joint occupants are treated as one taxpayer for purposes of determining the residential energy credit, the maximum amount of energy conservation expenditures or renewable energy source expenditures must be reduced by the total amount of such expenditures made in connection with the dwelling unit during prior calendar years in which any one of the residents of the unit during the current calendar year was a resident (whether made by the current resident or by an individual previously occupying the dwelling with the current resident). However, the preceding sentence shall not apply to prior expenditures no part of which was taken into account in computing the credits under section 23 of former section 44C for such years. Prior years' expenditures are not to be allocated among joint occupants to take into account the specific expenditures of each of the occupants in prior years.

(4) The rules of this paragraph may be illustrated by the following examples:

Example 1. Assume A and B have together made prior years' energy conservation expenditures of $1,600 (A having made $1,200 of expenditures and B having made $400) on their principal and jointly occupied residence. In the current year, each makes energy conservation expenditures of $300 with respect to the same residence. The maximum qualified expenditure with respect to the residence is reduced by the $1,600 of prior expenditures made by A and B. Therefore, only $400 of the $600 current expenditures are eligible as energy conservation expenditures. The resulting residential energy credit is $60 (15 percent of $400) of which $30 apiece will be allocated to A and B ($300/$600 × $60). The fact that A had previously computed the credit in prior years with respect to $1,200 of the total $1,600 of expenditures is irrelevant to the apportionment of the credit in the current year.

Example 2. In 1978, spouses C and D make $10,000 of renewable energy source expenditures with respect to their principal residence, half of which is paid by each spouse. No prior renewable energy source expenditures have been taken into account with respect to that residence by either C or D. C and D file separate returns for the calendar year. Under the joint occupancy rule, the maximum allowable renewable energy source credit with respect to C and D's principal residence is $2,200 (30 percent of the first $2,000, and 20 percent of the next $8,000 of expenditures). Half of this amount or $1,100, will be allowed to each spouse. If either spouse makes renewable energy source expenditures with respect to the same principal residence in future years, none of those expenditures would be qualified renewable energy source expenditures for which a credit can be claimed. That is, not more than $2,200 may be taken in the aggregate by C and D as a renewable energy source credit with respect to their principal residence.

Example 3. In 1978, E and F make energy conservation expenditures of $1,500 on their principal and jointly occupied residence. In 1979, E moves away and G becomes the other joint occupant of the residence. F and G make energy conservation expenditures of $1,000 in 1979. In 1980 F moves away and H moves in with G. G and H make energy conservation expenditures of $500. The maximum qualified expenditure made by F and G with respect to the residence is reduced by the $1,500 of prior expenditures made in 1978 by E and F. The maximum qualified expenditures made by G and H with respect to the residence is reduced only by the expenditures in prior years in connection with the residence during which either G or H was a joint occupant. Accordingly, the maximum qualified expenditures made by G and H with respect to the residence is reduced only by the $1,000 of prior expenditures made in 1979 by F and G.

(i) *Condominiums and cooperative housing corporations.* An individual who is a tenant stockholder in a cooperative housing corporation (as defined in section 216) or who is a member of a condominium management association with respect to a condominium which he or she owns shall be treated as having made a proportionate share of the energy conservation expenditures or renewable energy source expenditures of such corporation or association. The cooperative stockholder's allocable share of the expenditures is to be the same as his or her proportionate share of the cooperative's total outstanding stock (including any stock held by the corporation). However, in the case where only certain cooperative stockholders are assessed for the expenditures made by the cooperative housing corporation, only those cooperative stockholders that are assessed shall be treated as having made a share of the expenditures of such corporation. In such case, the cooperative stockholder's share of the expenditures is the amount that the stockholder is assessed. The allocable share of a condominium management association member's energy conservation of renewable energy source expenditures is the amount that the member is assessed (or would be assessed in the case where expenditures are from general funds) by the association as a result of such expenditures. The residential energy credit for a qualified expenditure is allowable for the year in which the association or corporation has completed original installation of the item (or has paid or incurred the expenditure, if later). For purposes of this paragraph, the term ''condominium management association'' means an organization meeting the requirements of section 528(c)(1) of the Code (other than subparagraph (E) of that section), with respect to a condominium project substantially all the units of which are used as residences.

(j) *Joint ownership of energy conservation property or renewable energy source property*—(1) *In general.* Energy conservation property renewable energy source property include property which is jointly owned by the taxpayer and another person (or persons) and installed in connection with two or more dwelling units. For example, the fact that a windmill, solar collector, or geothermal well and distribution system is owned by two or more individuals does not preclude its qualification as renewable energy source property. The amount of the credit allowable under section 23 shall be computed separately with respect to the amount of the expenditures made by each individual, subject to the limitations of $2,000 imposed by section 23(b)(1) and $10,000 imposed by section 23(b)(2), per dwelling units of jointly owned property. For example, in 1982, A, B, and C purchased as joint owners renewable energy source property that serviced two houses. One of the houses is jointly owned and occupied by A and B and the other is owned and occupied by C alone. The renewable energy source property cost $30,000 of which A paid $9,000, B paid $6,000, and C paid $15,000. A and B must share the $4,000 credit (40% of $10,000 maximum) with respect to the expenditures for the jointly owned house. Therefore, A is allowed a $2,400 credit ($4,000 times $9,000 divided by $9,000 plus $6,000) and B is allowed a $1,600 credit ($4,000 times $6,000 divided by $9,000 plus $6,000) with respect to the expenditures attributable to the jointly owned house. C is entitled to a credit of $4,000 with respect to the expenditures attributable to the other house.

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

Example. A, B, and C each has a separate principal residence. They agree to finance jointly the construction of a solar collector, each providing one-third of the costs and taking one-third of the output of the collector. Each will separately pay for the costs of connecting the solar collector with his or her principal residence. Provided the solar collector and connection equipment otherwise qualify as renewable energy source property, A, B, and C will each be considered to have made renewable energy source expenditures equal to one-third of the cost of the collector plus his or her separate connection costs. Such expenditures will be subject to the limitations and other rules separately applicable to A, B, and C with respect to each principal residence, such as those with respect to the $10 minimum (§1.23–1(d)(1)), prior expenditures (§1.23–1(d)(2)), residential use (paragraph (g) of this section), and joint occupancy (paragraph (h) of this section).

(k) *Basic adjustments.* If a credit is allowed under section 23 or former section 44C for any expenditure with respect to any property, the increase in the basis of that property which would (but for this paragraph) result from such expenditure shall be reduced by the amount of the credit allowed.

(l) *Recordkeeping*—(1) *In general.* No residential energy credit is allowable unless the taxpayer maintains the records described in paragraph (l)(2) of this section. The records shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

(2) *Records.* The taxpayer must maintain records that clearly identify the energy-conserving components and renewable energy source property with respect to which a residential energy credit is claimed, and substantiate their cost to the taxpayer, any labor costs properly allocable to them paid for by the taxpayer, and the method used for allocating such labor costs.

[T.D. 7717, 45 FR 57719, Aug. 29, 1980. Redesignated and amended by T.D. 8146, 52 FR 26672, July 16, 1987]

§ 1.23–4 Performance and quality standards. [Reserved]

[T.D. 7717, 45 FR 57721, Aug. 29, 1980. Redesignated by T.D. 8146, 52 FR 26672, July 16, 1987]

§ 1.23–5 Certification procedures.

(a) *Certification that an item meets the definition of an energy-conserving component or renewable energy source property.* Upon the request of a manufacturer of an item pursuant to paragraph (b) of this section which is supported by proof that the item is entitled to be certified, the Assistant Commissioner (Technical) shall certify (or shall notify the manufacturer that the request is denied) that:

(1) The item meets the definition of insulation (see §1.23–2(c)(1)).

(2) The item meets the definition of an other energy-conserving component specified in section 23(c)(4) or former section 44C(c)(4) see (§1.23–2(d)(4)).

(3) The item meets the definition of solar energy property (see §1.23–2(f)), wind energy property (see §1.23–2(g)), or geothermal energy property (see §1.23–2(h)).

(4) The item meets the definition of a category of energy-conserving component that has been added to the list of approved items pursuant to paragraph (d)(4)(viii) of §1.23–2.

(5) The item meets the definition of renewable energy source property that transmits or uses a renewable energy source that has been added to the list of approved renewable energy sources pursuant to paragraph (e)(2) of §1.23–2.

(b) *Procedure*—(1) *In general.* A manufacturer of an item desiring to apply under paragraph (a) shall submit the application to the Commissioner of Internal Revenue, Attention: Associate Chief Counsel (Technical), CC:C:E, 1111 Constitution Avenue NW., Washington, DC 20224. Upon being advised by the National Office, orally or in writing, that an adverse decision is contemplated a manufacturer may request a conference. The conference must be held within 21 calendar days from the date of that advice. Procedures for requesting an extension of the 21-day period and notifying the manufacturer of the Service's decision on that request are the same as those applicable to conferences on ruling requests by taxpayers (see section 9.05 of Rev. Proc. 80–20).

(2) *Contents of application.* The application shall include a description of the item (including appropriate design drawings and specifications) and an explanation of the purpose and function of the item. There shall accompany the application a declaration in the following form: "Under penalties of perjury, I declare that I have examined this application, including accompanying documents and, to the best of my knowledge and belief, the facts presented in support of the application are true, correct, and complete." The statement must be signed by the person or persons making the application.

(c) *Effect of certification under paragraph (a).* Certifications granted under paragraph (a)(1), (2), or (3) will be applied retroactively to April 20, 1977. However, certifications granted under paragraph (a) (4) or (5) will be applied retroactively only to the date the applicable energy-conserving component or renewable energy source was added by Treasury decision to the list of qualifying components or sources. Certification of an item under this section means that the applicable definitional requirement of §1.23–2 is considered satisfied in the case of any person claiming a residential energy credit with respect to such item. However, it does not relieve manufacturers of the need to establish that their items conform to performance and quality standards (if any) provided under §1.23–4 and that their items can reasonably be expected to remain in operation at least 3 years, in the case of insulation and other energy-conserving components, or at least 5 years, in the case of renewable energy source property.

[T.D. 7717, 45 FR 57721, Aug. 29, 1980. Redesignated and amended by T.D. 8146, 52 FR 26672, July 16, 1987]

§ 1.23–6 Procedure and criteria for additions to the approved list of energy-conserving components or renewable energy sources.

(a) *Procedures for additions to the list of energy-conserving components or renewable energy sources*—(1) *In general.* A manufacturer of an item (or a group of manufacturers) desiring to apply for addition to the approved list of energy-conserving components or renewable energy sources pursuant to paragraph (d)(4)(viii) or (e)(2) of §1.23–2 shall submit an application to the Internal Revenue Service, Attention: Associate Chief Counsel (Technical), CC:C:E, 1111 Constitution Avenue, NW., Washington, DC 20224. The term ''manufacturer'' includes a person who assembles an item or a system from components manufactured by other persons. The application shall provide the information required under paragraph (b) of this section. An application may request that more than one item be added to the approved list. It will be the responsibility of the Office of the Associate Chief Counsel (Technical) upon receipt of the application to determine whether all the information required under paragraph (b) of this section has been furnished with the application. If an application lacks essential information, the applicant will be advised of the additional information required. If the information (or a reasonable explanation of the reason why the information cannot be made available) is not forthcoming within 30 days of the date of that advice, the application will be closed and the applicant will be so informed. Any resubmission of information beyond the 30-day period will be treated as a new application. If the Office of the Associate Chief Counsel (Technical) already is considering an application with respect to the same or a similar item, it may consolidate applications. The Office of the Associate Chief Counsel will make a report and recommendation to the ad hoc advisory board as to whether each item that is the subject to an application should be added in accordance with the manufacturer's request to the approved list of energy-conserving components or renewable energy sources in light of the applicable criteria provided in paragraph (c) and the standards for Secretarial determination provided in paragraph (d) of this section. In making this recommendation, the Office of the Associate Chief Counsel shall consult with the Secretary of Energy and the Secretary of Housing and Urban Development (or their delegates) and any other appropriate Federal officers to obtain their views concerning the item in question. In addition, the Office of the Associate Chief Counsel may request from the manufacturer clarification of information submitted with the application. The Office of the Associate Chief Counsel shall report its recommendation and forward the application to the ad hoc advisory board for further consideration.

(2) *Ad hoc advisory board.* The Commissioner of Internal Revenue and the Assistant Secretary (Tax Policy) shall establish an ad hoc advisory board to consider applications and recommendations forwarded by the Office of the Associate Chief Counsel (Technical). If a finding in favor of addition of any item is made, the board shall report its recommendation and forward the application to the Commissioner for further consideration. If the item is approved by the Commissioner, the application will be forwarded to the Secretary (or his delegate) for further consideration.

The application will be closed with respect to an item if the board, the Commissioner, or the Secretary (or his delegate) determines that, under the applicable criteria or the standards for Secretarial determination, the item should not be added to the list of energy-conserving components or renewable energy sources.

(3) *Action on application.* (i) A final decision to grant or deny any application filed under paragraph (a)(1) shall be made within 1 year after the application and all information required to be filed with such request under paragraph (b) have been received by the Office of the Associate Chief Counsel (Technical). The applicant manufacturer shall be notified in writing of the final decision. In the event of a favorable determination, a regulation will be issued in accordance with the procedures contained in § 601.601 to include the item as an energy-conserving component or as a renewable energy source. A final decision to grant approval of an application is made when a Treasury decision adding the item (that is subject of the application) as an energy-conserving component or as a renewable energy source is published in the FEDERAL REGISTER.

(ii) The applicant manufacturer shall be entitled to a conference and be so notified anytime an adverse action is contemplated by the Office of the Associate Chief Counsel, the ad hoc advisory board, the Commissioner of Internal Revenue, or the Secretary (or his delegate) and no conference was previously conducted. Upon being advised in writing that an adverse recommendation or decision as to any item that is the subject of an application is contemplated, a manufacturer may request a conference. The conference must be held within 21 calendar days from the mailing of that advice. Procedures for requesting an extension of the 21-day period and notifying the manufacturer of the recommendation or decision with respect to that request are the same as those applicable to conferences on ruling requests by taxpayers. The applicant is entitled to only one conference. There is no right to another conference when a favorable recommendation or decision is reversed at a higher level.

(iii) A report of any application which has been denied during the preceding month and the reasons for the denial shall be published each month.

(b) *Contents of application.* The application by the manufacturer shall include the following information:

(1) A description of the item and the generic class to which it belongs, including any features relating to safe installation and use of the item. This description shall include appropriate design drawings and technical specifications (or representative drawings and specifications when application by a group of manufacturers).

(2) An explanation of the purpose, function, and each recommended use of the item.

(3) An estimate (and explanation of the estimation methods employed and the assumptions made) of the total number of units that would be sold for each recommended use during the first 4 years following the addition of the item to the approved list and of the total number that would be sold for each recommended use during that period in the absence of addition. If the item is sold in more than one size, the estimate shall indicate the projected sales for each size. This estimate shall reflect total industry sales of the item. Past industry sales information for each recommended use for the previous two years shall also be provided.

(4) Whether sufficient capacity is available to increase production to meet any increase in demand for the item, or for associated fuels and materials, caused by such addition. This determination shall be based on industry-wide data and not just the manufacturing capability of the applicant. If the applicant has the exclusive right to manufacture the item, this information shall also be provided in the application.

(5) An estimate (including estimation methods and assumptions) of the energy in Btu's of oil and natural gas used directly or indirectly per unit by the applicant in the manufacture of the item and other items necessary for its use, the type of energy source (e.g., oil, natural gas, coal, electricity), and the extent of its use in the manufacturing process of the item. The applicant must also provide a list of the major

components of the item and their composition and weight.

(6) Test data and experience data (where experience data is available) to substantiate for each recommended use the energy savings in Btu's that are claimed will be achieved by one unit during a period of one year. The data shall be obtained by controlled tests in which, if possible, the addition of the item is the only variable. If the item may be sold in various configurations, data shall be provided with respect to energy savings from each configuration with significantly different energy use characteristics. Test methods are to conform to recognized industry or government standards. This determination shall take into account the seasonal use of the item. If the energy savings of the item varies with climatic conditions, data shall be provided with respect to each climate zone. The applicant may use the Department of Energy's climatic zones for heating and cooling (see § 450.35 of 10 CFR part 450 (1980)).

(7) The impact of increased demand on the price of the item and the energy source used by the item.

(8) The energy source which will be replaced or conserved by the item, and, in the case of a request for addition to the approved list of renewable energy sources, data establishing that the energy source is inexhaustible.

(9) Data to show the total estimated savings of energy in Btu's attributable to reduced consumption of oil or natural gas whether directly or indirectly from use of the item, including assumptions underlying this estimate. If the consumption of both oil and natural gas will be reduced, data to show the energy savings in Btu's attributable to each shall be provided. The estimate is to be based on energy savings in Btu's per unit determined under paragraph (b)(6) of this section for the first four years of the useful life of the item and is to take into account only the additional units of the item estimated to be placed in service as a result of the addition using data obtained under paragraph (b)(3) of this section. If the item will result in reduction of oil or natural gas consumption by replacing an item which uses such an energy source, the application shall indicate the item replaced and the extent to which this reduction will occur.

(10) Geographical information if required under paragraph (b)(6) of this section to show the climatic zones of the country where the item is expected to be used, including an estimate of the total number of additional units to be placed in service during the first 4 years following the addition of the item in the area as a result of the addition of the item to the list of qualifying items.

(11) The retail cost of the item (or items if the item is sold in more than one size) including all installation costs necessary for safe and effective use.

(12) Whether the item is designed for residential use.

(13) The estimated useful life of the item and associated equipment necessary for its use.

(14) The type and amount of waste and emissions in weight per unit of energy saved resulting from use of the item.

(15) If the item might reasonably be suspected of presenting any health or safety hazard, test data to show that the item does not present such hazard.

With respect to applications for addition to the approved list of renewable energy sources, the term ''item'' as used in this paragraph refers to the property which uses the energy source and not the energy source itself. The application should clearly indicate whether the request is for addition to the approved list of energy-conserving components or renewable energy sources, identify the provisions for which data is being submitted, and present the data in the order requested. The tests required under this paragraph may be conducted by independent laboratories but the underlying data must be submitted along with the test results. There shall accompany the request a declaration in the following form: ''Under penalties of perjury, I declare that I have examined this application, including accompanying documents, and, to the best of my knowledge and belief, the facts presented in support of the application are true, correct and complete.'' The statement must be signed by the person or persons making the application. The declaration shall not be made by the taxpayer's representative.

(c) *Criteria for additions*—(1) *Additions to the approved list of energy-conserving components.* For an item to be considered for addition to the approved list of energy-conserving components, the manufacturer must show that the item increases the energy efficiency of a dwelling. For an item to be considered as increasing the energy efficiency of a dwelling, all of the following criteria must be met:

(i) The use of the item must improve the energy efficiency of the dwelling structure, structural components of the dwelling, hot water heating, or heating or cooling systems.

(ii) The use of the item must result, directly or indirectly, in a significant reduction in the consumption of oil or natural gas.

(iii) The increase in energy efficiency must be established by test data and in accordance with accepted testing standards.

(iv) The item must not present a safety, fire, environmental, or health hazard when properly installed.

(2) *Additions to the approved list of renewable energy sources.* For an energy source to be considered for addition to the approved list of renewable energy sources, the manufacturer must show that the following criteria are met:

(i) As in the case of solar, wind, and geothermal energy, the energy source must be an inexhaustible energy supply. Accordingly, wood and agricultural products and by-products are not considered renewable energy sources. Similarly, no exhaustible or depletable energy source (such as sources that are depletable under 611) will be considered.

(ii) The energy source must be capable of being used for heating or cooling a residential dwelling or providing hot water or electricity for use in such a dwelling.

(iii) A practical working device, machine, or mechanism, etc., must exist and be commercially available to use such renewable energy source.

(iv) The use of the renewable energy source must not present a significant safety, fire, environmental, or health hazard.

(d) *Standards for Secretarial determination*—(1) *In general.* The Secretary will not make any addition to the approved list of energy-conserving components or renewable energy sources unless the Secretary determines that—

(i) There will be a reduction in the total consumption of oil or natural gas as a result of the addition, and that reduction is sufficient to justify any resulting decrease in Federal revenues.

(ii) The addition will not result in an increased use of any item which is known to be, or reasonably suspected to be, environmentally hazardous or a threat to public health or safety, and

(iii) Available Federal subsidies do not make the addition unnecessary or inappropriate (in the light of the most advantageous allocation of economic resources).

(2) *Factors taken into account.* In making any determination under paragraph (d)(1)(i) of this section, the Secretary will—

(i) Make an estimate of the amount by which the addition will reduce oil and natural gas consumption, and

(ii) Determine whether the addition compares favorably, on the basis of the reduction in oil and natural gas consumption per dollar of cost to the Federal Government (including revenue loss), with other Federal programs in existence or being proposed.

(3) *Factors taken into account in making estimates.* In making any estimate under subparagraph (2)(i), the Secretary will take into account (among other factors)—

(i) The extent to which the use of any item will be increased as a result of the addition,

(ii) Whether sufficient capacity is available to increase production to meet any increase in demand for the item or associated fuels and materials caused by the addition,

(iii) The amount of oil and natural gas used directly or indirectly in the manufacture of the item and other items necessary for its use,

(iv) The estimated useful life of the item, and

(v) The extent additional use of the item leads, directly or indirectly, to the reduced use of oil or natural gas.

Indirect uses of oil or natural gas include use of electricity derived from oil or natural gas.

(e) *Effective date of addition to approved lists.* In the case of additions to the approved list of energy-conserving components or renewable energy sources, the credit allowable by § 1.23–1 shall apply with respect to expenditures which are made on or after the date a Treasury decision amending the regulations pursuant to the application is published in the FEDERAL REGISTER. However, the Secretary may prescribe by regulations that expenditures for additions made on or after the date referred to in the preceding sentence and before the close of the taxable year in which such date occurs shall be taken into account in the following taxable year. Additions to the list will be subject to the performance and quality standards (if any) provided under § 1.23–4 which are in effect at the time of the addition. Furthermore, any addition made to the approved list will be subject to reevaluation by the Secretary for the purpose of determining whether the item still meets the requisite criteria and standards for addition to the list. If it is determined by the Secretary that an item no longer meets the requisite criteria, the Secretary will amend the regulations to delete the item from the approved list. Removal of an item from the list will be prospective from the date a Treasury decision amending the regulations is published in the FEDERAL REGISTER.

(Secs. 44C and 7805 of the Internal Revenue Code of 1954 (92 Stat. 3175, 26 U.S.C. 44C; 68A Stat. 917, 26 U.S.C. 7805). The amendments to the Statement of Procedural Rules are issued under the authority contained in 5 U.S.C. 301 and 552)

[T.D. 7861, 47 FR 56331, Dec. 16, 1982. Redesignated and amended by T.D. 8146, 52 FR 26673, July 16, 1987]

§ 1.25–1T Credit for interest paid on certain home mortgages (Temporary).

(a) *In general.* Section 25 permits States and political subdivisions to elect to issue mortgage credit certificates in lieu of qualified mortgage bonds. An individual who holds a qualified mortgage credit certificate (as defined in § 1.25–3T) is entitled to a credit against his Federal income taxes. The amount of the credit depends upon (1) the amount of mortgage interest paid or accrued during the year and (2) the applicable certificate credit rate. See § 1.25–2T. The amount of the deduction under section 163 for interest paid or accrued during any taxable year is reduced by the amount of the credit allowable under section 25 for such year. See § 1.163–6T. The holder of a qualified mortgage credit certificate may be entitled to additional withholding allowances. See section 3402 (m) and the regulations thereunder.

(b) *Definitions.* For purposes of §§ 1.25–2T through 1.25–8T and this section, the following definitions apply:

(1) *Mortgage.* The term ''mortgage'' includes deeds of trust, conditional sales contracts, pledges, agreements to hold title in escrow, and any other form of owner financing.

(2) *State.* (i) The term ''State'' includes a possession of the United States and the District of Columbia.

(ii) Mortgage credit certificates issued by or on behalf of any State or political subdivision (''governmental unit'') by constituted authorities empowered to issue such certificates are the certificates of such governmental unit.

(3) *Qualified home improvement loan.* The term ''qualified home improvement loan'' has the meaning given that term under section 103A (1)(6) and the regulations thereunder.

(4) *Qualified rehabilitation loan.* The term ''qualified rehabilitation loan'' has the meaning given that term under section 103A (1)(7)(A) and the regulations thereunder.

(5) *Single-family and owner-occupied residences.* The terms ''single-family'' and ''owner-occupied'' have the meaning given those terms under section 103A (1)(9) and the regulations thereunder.

(6) *Constitutional home rule city.* The term ''constitutional home rule city'' means, with respect to any calendar year, any political subdivision of a State which, under a State constitution which was adopted in 1970 and effective on July 1, 1971, had home rule powers on the 1st day of the calendar year.

(7) *Targeted area residence.* The term ''targeted area residence'' has the meaning given that term under section 103A (k) and the regulations thereunder.

(8) *Acquisition cost.* The term ''acquisition cost'' has the meaning given that term under section 103A (1)(5) and the regulations thereunder.

(9) *Average area purchase price.* The term ''average area purchase price'' has the meaning given that term under subparagraphs (2), (3), and (4) of section 103A (f) and the regulations thereunder. For purposes of this paragraph (b)(9), all determinations of average area purchase price shall be made with respect to residences as that term is defined in section 103A and the regulations thereunder.

(10) *Total proceeds.* The ''total proceeds'' of an issue is the sum of the products determined by multiplying—

(i) The certified indebtedness amount of each mortgage credit certificate issued pursuant to such issue, by

(ii) The certificate credit rate specified in such certificate.

Each qualified mortgage credit certificate program shall be treated as a separate issue of mortgage credit certificates.

(11) *Residence.* The term ''residence'' includes stock held by a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216(b) (1) and (2)). It does not include property such as an appliance, a piece of furniture, a radio, etc., which, under applicable local law, is not a fixture. The term also includes any manufactured home which has a minimum of 400 square feet of living space and a minimum width in excess of 102 inches and which is of a kind customarily used at a fixed location. The preceding sentence shall not apply for purposes of determining the average area purchase price for single-family residences, nor shall it apply for purposes of determining the State ceiling amount. The term ''residence'' does not, however, include recreational vehicles, campers, and other similar vehicles.

(12) *Related person.* The term ''related person'' has the meaning given that term under section 103(b)(6)(C)(i) and §1.103–10(e)(1).

(13) *Date of issue.* A mortgage credit certificate is considered issued on the date on which a closing agreement is signed with respect to the certified indebtedness amount.

(c) *Affidavits.* For purposes of §§1.25–1T through 1.25–8T, an affidavit filed in connection with the requirements of §§1.25–1T through 1.25–8T shall be made under penalties of perjury. Applicants for mortgage credit certificates who are required by a lender or the issuer to sign affidavits must be informed that any fraudulent statement will result in (1) the revocation of the individual's mortgage credit certificate, and (2) a $10,000 penalty under section 6709. Other persons required by a lender or an issuer to provide affidavits must receive similar notice. A person may not rely on an affidavit where that person knows or has reason to know that the information contained in the affidavit is false.

[T.D. 8023, 50 FR 19346, May 8, 1985]

§ 1.25–2T Amount of credit (Temporary).

(a) *In general.* Except as otherwise provided, the amount of the credit allowable for any taxable year to an individual who holds a qualified mortgage credit certificate is equal to the product of the certificate credit rate (as defined in paragraph (b)) and the amount of the interest paid or accrued by the taxpayer during the taxable year on the certified indebtedness amount (as defined in paragraph (c)).

(b) *Certificate credit rate*—(1) *In general.* For purposes of §§1.25–1T through 1.25–8T, the term ''certificate credit rate'' means the rate specified by the issuer on the mortgage credit certificate. The certificate credit rate shall not be less than 10 percent nor more than 50 percent.

(2) *Limitation in certain States.* (i) In the case of a State which—

(A) Has a State ceiling for the calendar year in which an election is made that exceeds 20 percent of the average annual aggregate principal amount of mortgages executed during the immediately preceding 3 calendar years for single-family owner-occupied residences located within the jurisdiction of such State, or

(B) Issued qualified mortgage bonds in an aggregate amount less than $150 million for calendar year 1983.

the certificate credit rate for any mortgage credit certificate issued under such program shall not exceed 20 percent unless the issuing authority submits a plan to the Commissioner to ensure that the weighted average of the certificate credit rates in such mortgage credit certificate program does not exceed 20 percent and the Commissioner approves such plan. For purposes of determining the average annual aggregate principal amount of mortgages executed during the immediately preceding 3 calendar years for single-family owner-occupied residences located within the jurisdiction of such State, an issuer may rely upon the amount published by the Treasury Department for such calendar years. An issuer may rely on a different amount from that safe-harbor limitation where the issuer has made a more accurate and comprehensive determination of that amount. The weighted average of the certificate credit rates in a mortgage credit certificate program is determined by dividing the sum of the products obtained by multiplying the certificate credit rate of each certificate by the certified indebtedness amount with respect to that certificate by the sum of the certified indebtedness amounts of the certificates issued. See section 103A(g) and the regulations thereunder for the definition of the term ''State ceiling''.

(ii) The following example illustrates the application of this paragraph (b)(2):

Example. City Z issues four qualified mortgage credit certificates pursuant to its qualified mortgage credit certificate program. H receives a certificate with a certificate credit rate of 30 percent and a certified indebtedness amount of $50,000. I receives a certificate with a certificate credit rate of 25 percent and a certified indebtedness amount of $100,000. J and K each receive certificates with certificate credit rates of 10 percent; their certified indebtedness amounts are $50,000 and $100,000, respectively. The weighted average of the certificate credit rates is determined by dividing the sum of the products obtained by multiplying the certificate credit rate of each certificate by the certified indebtedness amount with respect to that certificate ((.3 × $50,000) + (.25 × $100,000) + (.1 × $50,000) + (.1 × $100,000)) by the sum of the certified indebtedness amounts of the certificates issued ($50,000 + $100,000 + $50,000 + $100,000). Thus, the weighted average of the certificate credit rates is 18.33 percent ($55,000/$300,000).

(c) *Certified indebtedness amount*—(1) *In general.* The term ''certified indebtedness amount'' means the amount of indebtedness which is—

(i) Incurred by the taxpayer—

(A) To acquire his principal residence, §1.25–2T(c)(1)(i),

(B) As a qualified home improvement loan, or

(C) As a qualified rehabilitation loan, and

(ii) Specified in the mortgage credit certificate.

(2) *Example.* The following example illustrates the application of this paragraph:

Example. On March 1, 1986, State X, pursuant to its qualified mortgage credit certificate program, provides a mortgage credit certificate to B. State X specifies that the maximum amount of the mortgage loan for which B may claim a credit is $65,000. On March 15, B purchases for $67,000 a single-family dwelling for use as his principal residence. B obtains from Bank M a mortgage loan for $60,000. State X, or Bank M acting on behalf of State X, indicates on B's mortgage credit certificate that the certified indebtedness amount of B's loan is $60,000. B may claim a credit under section 25 (e) based on this amount.

(d) *Limitation on credit*—(1) *Limitation where certificate credit rate exceeds 20 percent.* (i) If the certificate credit rate of any mortgage credit certificate exceeds 20 percent, the amount of the credit allowed to the taxpayer by section 25(a)(1) for any year shall not exceed $2,000. Any amount denied under this paragraph (d)(1) may not be carried forward under section 25(e)(1) and paragraph (d)(2) of this section.

(ii) If two or more persons hold interests in any residence, the limitation of paragraph (d)(1)(i) shall be allocated among such persons in proporation to their respective interests in the residence.

(2) *Carryforward of unused credit.* (i) If the credit allowable under section 25 (a) and §1.25–2T for any taxable year exceeds the applicable tax limit for that year, the excess (the ''unused credit'') will be a carryover to each of the 3 succeeding taxable years and, subject to the limitations of paragraph

(d)(2)(ii), will be added to the credit allowable by section 25 (a) and §1.25–2T for that succeeding year.

(ii) The amount of the unused credit for any taxable year (the ''unused credit year'') which may be taken into account under this paragraph (d)(2) for any subsequent taxable year may not exceed the amount by which the applicable tax limit for that subsequent taxable year exceeds the sum of (A) the amount of the credit allowable under section 25 (a) and §1.25–1T for the current taxable year, and (B) the sum of the unused credits which, by reason of this paragraph (d)(2), are carried to that subsequent taxable year and are attributable to taxable years before the unused credit year. Thus, if by reason of this paragraph (d)(2), unused credits from 2 prior taxable years are carried forward to a subsequent taxable year, the unused credit from the earlier of those 2 prior years must be taken into account before the unused credit from the later of those 2 years is taken into account.

(iii) For purposes of this paragraph (d)(2) the term ''applicable tax limit'' means the limitation imposed by section 26 (a) for the taxable year reduced by the sum of the credits allowable for that year under section 21, relating to expenses for household and dependent care services necessary for gainful employment, section 22, relating to the credit for the elderly and the permanently disabled, section 23, relating to the residential energy credit, and section 24, relating to contributions to candidates for public office. The limitation imposed by section 26 (a) for any taxable year is equal to the taxpayer's tax liability (as defined in section 26 (b)) for that year.

(iv) The following examples illustrate the application of this paragraph (d)(2):

Example 1. (i) B, a calendar year taxpayer, holds a qualified mortgage credit certificate. For 1986 B's applicable tax limit (*i.e.*, tax liability) is $1,100. The amount of the credit under section 25 (a) and §1.25–2T for 1986 is $1,700. For 1986 B is not entitled to any of the credits described in sections 21 through 24. Under §1.25–2T (d)(2), B's unused credit for 1986 is $600, and B is entitled to carry forward that amount to the 3 succeeding years.

(ii) For 1987 B's applicable tax limit is $1,500, the amount of the credit under section 25 (a) and §1.25–2T is $1,700, and the unused credit is $200. For 1988 B's applicable tax limit is $2,000, the amount of the credit under section 25 (a) and §1.25–2T is $1,300, and there is no unused credit. For 1987 and 1988 B is not entitled to any of the credits described in sections 21 through 24. No portion of the unused credit for 1986 my be used in 1987. For 1988 B is entitled to claim a credit of $2,000 under section 25 (a) and §1.25–2T, consisting of a $1,300 credit for 1988, the $600 unused credit for 1986, and $100 of the $200 unused credit for 1987. In addition, B may carry forward the remaining unused credit for 1987 ($100) to 1989 and 1990.

Example 2. The facts are the same as in Example (1) except that for 1988 B is entitled to a credit of $400 under section 23. B's applicable tax limit for 1988 is $1,600 ($2,000 less $400). For 1988 B is entitled to claim a credit of $1,600 under section 25 (a) and §1.25–2T, consisting of a $1,300 credit for 1988 and $300 of the unused credit for 1986. In addition, B may carry forward the remaining unused credits of $300 for 1986 to 1989 and of $200 for 1987 to 1989 and 1990.

[T.D. 8023, 50 FR 19346, May 8, 1985]

§1.25–3 Qualified mortgage credit certificate.

(a)–(g)(1)(ii) [Reserved]. For further guidance, see §1.25–3T(a) through (g)(1)(ii).

(g)(1)(iii) *Reissued certificate exception.* See paragraph (p) of this section for rules regarding the exception in the case of refinancing existing mortgages.

(g)(2)–(o) [Reserved]. For further guidance, see §1.25–3T(g)(2) through (o).

(p) *Reissued certificates for certain refinancings*—(1) *In general.* If the issuer of a qualified mortgage credit certificate reissues a certificate in place of an existing mortgage credit certificate to the holder of that existing certificate, the reissued certificate is treated as satisfying the requirements of this section. The period for which the reissued certificate is in effect begins with the date of the refinancing (that is, the date on which interest begins accruing on the refinancing loan).

(2) *Meaning of existing certificate.* For purposes of this paragraph (p), a mortgage credit certificate is an existing certificate only if it satisfies the requirements of this section. An existing certificate may be the original certificate, a certificate issued to a transferee under §1.25–3T(h)(2)(ii), or a certificate previously reissued under this paragraph (p).

(3) *Limitations on reissued certificate*. An issuer may reissue a mortgage credit certificate only if all of the following requirements are satisfied:

(i) The reissued certificate is issued to the holder of an existing certificate with respect to the same property to which the existing certificate relates.

(ii) The reissued certificate entirely replaces the existing certificate (that is, the holder cannot retain the existing certificate with respect to any portion of the outstanding balance of the certified mortgage indebtedness specified on the existing certificate).

(iii) The certified mortgage indebtedness specified on the reissued certificate does not exceed the remaining outstanding balance of the certified mortgage indebtedness specified on the existing certificate.

(iv) The reissued certificate does not increase the certificate credit rate specified in the existing certificate.

(v) The reissued certificate does not result in an increase in the tax credit that would otherwise have been allowable to the holder under the existing certificate for any taxable year. The holder of a reissued certificate determines the amount of tax credit that would otherwise have been allowable by multiplying the interest that was scheduled to have been paid on the refinanced loan by the certificate rate of the existing certificate. In the case of a series of refinancings, the tax credit that would otherwise have been allowable is determined from the amount of interest that was scheduled to have been paid on the original loan and the certificate rate of the original certificate.

(A) In the case of a refinanced loan that is a fixed interest rate loan, the interest that was scheduled to be paid on the refinanced loan is determined using the scheduled interest method described in paragraph (p)(3)(v)(C) of this section.

(B) In the case of a refinanced loan that is not a fixed interest rate loan, the interest that was scheduled to be paid on the refinanced loan is determined using either the scheduled interest method described in paragraph (p)(3)(v)(C) of this section or the hypothetical interest method described in paragraph (p)(3)(v)(D) of this section.

(C) The scheduled interest method determines the amount of interest for each taxable year that was scheduled to have been paid in the taxable year based on the terms of the refinanced loan including any changes in the interest rate that would have been required by the terms of the refinanced loan and any payments of principal that would have been required by the terms of the refinanced loan (other than repayments required as a result of any refinancing of the loan).

(D) The hypothetical interest method (which is available only for refinanced loans that are not fixed interest rate loans) determines the amount of interest treated as having been scheduled to be paid for a taxable year by constructing an amortization schedule for a hypothetical self-amortizing loan with level payments. The hypothetical loan must have a principal amount equal to the remaining outstanding balance of the certified mortgage indebtedness specified on the existing certificate, a maturity equal to that of the refinanced loan, and interest equal to the annual percentage rate (APR) of the refinancing loan that is required to be calculated for the Federal Truth in Lending Act.

(E) A holder must consistently apply the scheduled interest method or the hypothetical interest method for all taxable years beginning with the first taxable year the tax credit is claimed by the holder based upon the reissued certificate.

(4) *Examples*. The following examples illustrate the application of paragraph (p)(3)(v) of this section:

Example 1. A holder of an existing certificate that meets the requirements of this section seeks to refinance the mortgage on the property to which the existing certificate relates. The final payment on the holder's existing mortgage is due on December 31, 2000; the final payment on the new mortgage would not be due until January 31, 2004. The holder requests that the issuer provide to the holder a reissued mortgage credit certificate in place of the existing certificate. The requested certificate would have the same certificate credit rate as the existing certificate. For each calendar year through the year 2000, the credit that would be allowable to the holder with respect to the new mortgage under the requested certificate would not exceed the credit allowable for that year under the existing certificate. The requested certificate, however, would allow the holder credits for the years 2001 through 2004, years for which, due to the earlier scheduled retirement of the existing mortgage, no credit would be allowable under the existing certificate. Under paragraph (p)(3)(v) of this section, the issuer may not reissue the certificate as requested because, under the existing certificate, no credit would be allowable for the years 2001 through 2004. The issuer may, however, provide a reissued certificate that limits the amount of the credit allowable in each year to the amount allowable under the existing certificate. Because the existing certificate would allow no credit after December 31, 2000, the reissued certificate could expire on December 31, 2000.

Example 2. (a) The facts are the same as *Example 1* except that the existing mortgage loan has a variable rate of interest and the refinancing loan will have a fixed rate of interest. To determine whether the limit under paragraph (p)(3)(v) of this section is met for any taxable year, the holder must calculate the amount of credit that otherwise would have been allowable absent the refinancing. This requires a determination of the amount of interest that would have been payable on the refinanced loan for the taxable year. The holder may determine this amount by—

(1) Applying the terms of the refinanced loan, including the variable interest rate or rates, for the taxable year as though the refinanced loan continued to exist; or

(2) Obtaining the amount of interest, and calculating the amount of credit that would have been available, from the schedule of equal payments that fully amortize a hypothetical loan with the principal amount equal to the remaining outstanding balance of the certified mortgage indebtedness specified on the existing certificate, the interest equal to the annual percentage rate (APR) of the refinancing loan, and the maturity equal to that of the refinanced loan.

(b) The holder must apply the same method for each taxable year the tax credit is claimed based upon the reissued mortgage credit certificate.

(5) *Coordination with Section 143(m)(3).* A refinancing loan underlying a reissued mortgage credit certificate that replaces a mortgage credit certificate issued on or before December 31, 1990, is not a federally subsidized indebtedness for the purposes of section 143(m)(3) of the Internal Revenue Code.

[T.D. 8692, 61 FR 66214, Dec. 17, 1996]

§ 1.25–3T Qualified mortgage credit certificate (Temporary).

(a) *Definition of qualified mortgage credit certificate.* For purposes of §§ 1.25–1T through 1.25–8T, the term "qualified mortgage credit certificate" means a certificate that meets all of the requirements of this section.

(b) *Qualified mortgage credit certificate program.* A certificate meets the requirements of this paragraph if it is issued under a qualified mortgage credit certificate program (as defined in § 1.25–4T).

(c) *Required form and information.* A certificate meets the requirements of this paragraph if it is in the form specified in § 1.25–6T and if all the information required by the form is specified on the form.

(d) *Residence requirement*—(1) *In general.* A certificate meets the requirements of this paragraph only if it is provided in connection with the acquisition, qualified rehabilitation, or qualified home improvement of a residence, that is—

(i) A single-family residence (as defined in § 1.25–1T(b)(5)) which, at the time the financing on the residence is executed or assumed, can reasonably be expected by the issuer to become (or, in the case of a qualified home improvement loan, to continue to be) the principal residence (as defined in section 1034 and the regulations thereunder) of the holder of the certificate within a reasonable time after the financing is executed or assumed, and

(ii) Located within the jurisdiction of the governmental unit issuing the certificate.

See section 103a(d) and the regulations thereunder for further definitions and requirements.

(2) *Certification procedure.* The requirements of this paragraph will be met if the issuer or its agent obtains from the holder of the certificate an affidavit stating his intent to use (or, in the case of a qualified home improvement loan, that he is currently using and intends to continue to use) the residence as his principal residence within a reasonable time (e.g., 60 days) after the mortgage credit certificate is issued and stating that the holder will notify the issuer of the mortgage credit certificate if the residence ceases to be his principal residence. The affidavit must also state facts that are sufficient for the issuer or his agent to determine whether the residence is located within the jurisdiction of the

issuer that issued the mortgage credit certificate.

(e) *3-year requirement*—(1) *In general.* A certificate meets the requirements of this paragraph only if the holder of the certificate had no present ownership interest in a principal residence at any time during the 3-year period prior to the date on which the mortgage on the residence in connection with which the certificate is provided is executed. For purposes of the preceding sentence, the holder's interest in the residence with respect to which the certificate is being provided shall not be taken into account. See section 103A(e) and the regulations thereunder for further definitions and requirements.

(2) *Exceptions.* Paragraph (e)(1) shall not apply with respect to—

(i) Any certificate provided with respect to a targeted area residence (as defined in §1.25–1T(b)(7)),

(ii) Any qualified home improvement loan (as defined in §1.25–1T(b)(3)), and

(iii) Any qualified rehabilitation loan (as defined in §1.25–1T(b)(4)).

(3) *Certification procedure.* The requirements of paragraph (e)(1) will be met if the issuer or its agent obtains from the holder of the certificate an affidavit stating that he had no present ownership interest in a principal residence at any time during the 3-year period prior to the date of which the certificate is issued and the issuer or its agent obtains from the applicant copies of the applicant's Federal tax returns for the preceding 3 years and examines each statement to determine whether the applicant has claimed a deduction for taxes on property which was the applicant's principal residence pursuant to section 164(a)(1) or a deduction pursuant to section 163 for interest paid on a mortgage secured by property which was the applicant's principal residence. Where the mortgage is executed during the period between January 1 and February 15 and the applicant has not yet filed has Federal income tax return with the Internal Revenue Service, the issuer may, with respect to such year, rely on an affidavit of the applicant that the applicant is not entitled to claim deductions for taxes or interest on indebtedness with respect to property constituting his principal residence for the preceding calendar year. In the alternative, when applicable, the holder may provide an affidavit stating that one of the exceptions provided in paragraph (e)(2) applies.

(4) *Special rule.* An issuer may submit a plan to the Commissioner for distributing certificates, in an amount not to exceed 10 percent of the proceeds of the issue, to individuals who do not meet the requirements of this paragraph. Such plan must describe a procedure for ensuring that no more than 10 percent of the proceeds of a such issue will be used to provide certificates to such individuals. If the Commissioner approves the issuer's plan, certificates issued in accordance with the terms of the plan to holders who do not meet the 3-year requirement do not fail to satisfy the requirements of this paragraph.

(f) *Purchase price requirement*—(1) *In general.* A certificate meets the requirements of this paragraph only if the acquisition cost (as defined in §1.25–1T(b)(8)) of the residence, other than a targeted area residence, in connection with which the certificate is provided does not exceed 110 percent of the average area purchase price (as defined in §1.25–1T(b)(9)) applicable to that residence. In the case of a targeted area residence (as defined in §1.251T(b)(7)) the acquisition cost may not exceed 120 percent of the average area purchase price applicable to such residence. See section 1093A(f) and the regulations thereunder for further definitions and requirements.

(2) *Certification procedure.* The requirements of paragraph (f)(1) will be met if the issuer or its agent obtains affidavits executed by the seller and the buyer that state these requirements have been met. Such affidavits must include an itemized list of—

(i) Any payments made by the buyer (or a related person) or for the benefit of the buyer,

(ii) If the residence is incomplete, an estimate of the reasonable cost of completing the residence, and

(iii) If the residence is purchased subject to a ground rent, the capitalized value of the ground rent.

The issuer or his agent must examine such affidavits and determine whether, on the basis of information contained therein, the purchase price requirement is met.

(g) *New mortgage requirement*—(1) *In general.* (i) A certificate meets the requirements of this paragraph only if the certificate is not issued in connection with the acquisition or replacement of an existing mortgage. Except in the case of a qualified home improvement loan, the certificate must be issued to an individual who did not have a mortgage (whether or not paid off) on the residence with respect to which the certificate is issued at any time prior to the execution of the mortgage.

(ii) *Exceptions.* For purposes of this paragraph, a certificate used in connection with the replacement of—

(A) Construction period loans,

(B) Bridge loans or similar temporary initial financing, and

(C) In the case of a qualified rehabilitation loan, an existing mortgage,

shall not be treated as being used to acquire or replace an existing mortgage. Generally, temporary initial financing is any financing which has a term of 24 months or less. See section 103A(j)(1) and the regulations thereunder for examples illustrating the application of these requirements.

(2) *Certification procedure.* The requirements of paragraph (g)(1) will be met if the issuer or its agent obtains from the holder of the certificate an affidavit stating that the mortage being acquired in connection with the certificate will not be used to acquire or replace an existing mortgage (other than one that falls within the exceptions described in paragraph (g)(1)(ii)).

(h) *Transfer of mortgage credit certificates*—(1) *In general.* A certificate meets the requirements of this paragraph only if it is (i) not transferable or (ii) transferable only with the approval of the issuer.

(2) *Transfer procedure.* A certificate that is transferred with the approval of the issuer is a qualified mortgage credit certificate in the hands of the transferee only if each of the following requirements is met:

(i) The transferee assumed liability for the remaining balance of the certified indebtedness amount in connection with the acquisition of the residence from the transferor,

(ii) The issuer issues a new certificate to the transferee, and

(iii) The new certificate meets each of the requirements of paragraphs (d), (e), (f), and (i) of this section based on the facts as they exist at the time of the transfer as if the mortgage credit certificate were being issued for the first time. For example, the purchase price requirement is to be determined by reference to the average area purchase price at the time of the assumption and not when the mortgage credit certificate was originally issued.

(3) *Statement on certificate.* The requirements of paragraph (h)(1) will be met if the mortgage credit certificate states that the certificate may not be transferred or states that the certificate may not be transferred unless the issuer issues a new certificate in place of the original certificate.

(i) *Prohibited mortgages*—(1) *In general.* A certificate meets the requirements of this paragraph only if it is issued in connection with the acquisition of a residence none of the financing of which is provided from the proceeds of—

(i) A qualified mortgage bond (as defined under section 103A(c)(1) and the regulations thereunder), or

(ii) A qualified veterans' mortgage bond (as defined under section 103A(c)(3) and the regulations thereunder).

Thus, for example, if a mortgagor has a mortgage on his principal residence that was obtained from the proceeds of a qualified mortgage bond, a mortgage credit certificate issued to such mortgagor in connection with a qualified home improvement loan with respect to such residence is not a qualified mortgage credit certificate. If, however, the financing provided from the proceeds of the qualified mortgage bond had been paid off in full, the certificate would be a qualified mortgage credit certificate (assuming all the requirements of this paragraph are met).

(2) *Certification procedure.* The requirements of paragraph (i)(1) will be met if the issuer or its agent obtains from the holder of the certificate an affidavit stating that no portion of the financing of the residence in connection with which the certificate is issued is provided from the proceeds of

a qualified mortgage bond or a qualified veterans' mortgage bond.

(j) *Particular lenders*—(1) *In general.* Except as otherwise provided in paragraph (j)(2), a certificate meets the requirements of this paragraph only if the certificate is not limited to indebtedness incurred from particular lenders. A certificate is limited to indebtedness from particular lenders if the issuer, directly or indirectly, prohibits the holder of a certificate from obtaining financing from one or more lenders or requires the holder of a certificate to obtain financing from one or more lenders. For purposes of this paragraph, a lender is any person, including an issuer of mortgage credit certificates, that provides financing for the acquisition, qualified rehabilitation, or qualified home improvement of a residence.

(2) *Exception.* A mortgage credit certificate that is limited to indebtedness incurred from particular lenders will not cease to meet the requirements of this paragraph if the Commissioner approves the basis for such limitation. The Commissioner may approve the basis for such limitation if the issuer establishes to the satisfaction of the Commissioner that it will result in a significant economic benefit to the holders of mortgage credit certificates (e.g., substantially lower financing costs) compared to the result without such limitation.

(3) *Taxable bonds.* The requirements of this paragraph do not prevent an issuer of mortgage credit certificates from issuing mortgage subsidy bonds (other than obligations described in section 103 (a)) the proceeds of which are to be used to provide mortgages to holders of mortgage credit certificates provided that the holders of such certificates are not required to obtain financing from the proceeds of the bond issue. See §1.25–4T (h) with respect to permissible fees.

(4) *Lists of participating lenders.* The requirements of this paragraph do not prohibit an issuer from maintaining a list of lenders that have stated that they will make loans to qualified holders of mortgage credit certificates, provided that (i) the issuer solicits such statements in a public notice similar to the notice described in §1.25–7T, (ii) lenders are provided a reasonable period of time in which to express their interest in being included in such a list, and (iii) holders of mortgage credit certificates are not required to obtain financing from the lenders on the list. If an issuer maintains such a list, it must update the list at least annually.

(5) *Certification procedure.* The requirements of this paragraph will be met if (i) the issuer or its agent obtains from the holder of the certificate an affidavit stating that the certificate was not limited to indebtedness incurred from particular lenders or (ii) the issuer obtains a ruling from the Commissioner under paragraph (j)(2).

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

Example 1. Under its mortgage credit certificate program, County Z distributes all the certificates to be issued to a group of 60 participating lenders. Residents of County Z may obtain mortgage credit certificates only from the participating lenders and only in connection with the acquisition of mortgage financing from that lender or one of the other participating lenders. Certificates issued under this program do not meet the requirements of this paragraph since the certificates are limited to indebtedness incurred from particular lenders. The certificates, therefore, are not qualified mortgage credit certificates.

Example 2. In connection with its mortgage credit certificate program, County Y arranges with Bank P for a line of credit to be used to provide mortgage financing to holders of mortgage credit certificates. County Y, pursuant to paragraph (j)(4), maintains a list of lenders participating in the mortgage credit certificate program. County Y distributes the certificates directly to applicants. Holders of the certificates are not required to obtain mortgage financing through the line of credit or through a lender on the list of participating lenders. Certificates issued pursuant to County Y's program satisfy the requirements of this paragraph.

(k) *Developer certification*—(1) *In general.* A mortgage credit certificate that is allocated by the issuer to any particular development meets the requirements of this paragraph only if the developer provides a certification to the purchaser of the residence and the issuer stating that the purchase price of that residence is not higher than the price would be if the issuer had not allocated mortgage credit certificates to the development. The certification must be made by the developer if a natural person or, if not, by a duly authorized official of the developer.

(2) *Certification procedure.* The requirements of this paragraph will be met if the issuer or its agent obtains from the holder of the certificate an affidavit stating that he has received from the developer the certification described in this paragraph.

(l) *Expiration*—(1) *In general.* A certificate meets the requirements of this paragraph if the certified indebtedness amount is incurred prior to the close of the second calendar year following the calendar year for which the issuer elected not to issue qualified mortgage bonds under §1.25–4T with respect to that issue of mortgage credit certificates. Thus, for example, if on October 1, 1984, an issuing authority elects under §1.25–4T not to issue qualified mortgage bonds, a mortgage credit certificate provided under that program does not meet the requirements of this paragraph unless the indebtedness is incurred on or before December 31, 1986.

(2) *Issuer-imposed expiration dates.* An issuer of mortgage credit certificates may provide that a certificate shall expire if the holder of the certificate does not incure certified indebtedness by a date that is prior to the expiration date provided in paragraph (l)(1). A certificate that expires prior to the date provided in paragraph (l)(1) may be reissued provided that the requirements of this paragraph are met.

(m) *Revocation.* A certificate meets the requirements of this paragraph only if it has not been revoked. Thus, the credit provided by section 25 and §1.25–1T does not apply to interest paid or accrued following the revocation of a certificate. A certificate is treated as revoked when the residence to which the certificate relates ceases to be the holder's principal residence. An issuer may revoke a mortgage credit certificate if the certificate does not meet all the requirements of §1.25–3T (d), (e), (f), (g), (h), (i), (j), (k), and (n). The certificate is revoked by the issure's notifying the holder of the certificate and the Internal Revenue Service that the certificate is revoked. The notice to the Internal Revenue Service shall be made as part of the report requred by §1.25–8T (b)(2).

(n) *Interest paid to related person*—(1) *In general.* A certificate does not meet the requirements of this paragraph if interest on the certified indebtedness amount is paid to a person who is a related person to the holder of the certificate.

(2) *Certification procedure.* The requirements of this paragraph will be met if the issuer or its agent obtains from the holder of the certificate an affidavit stating that a related person does not have, and is not expected to have, an interest as a creditor in the certified indebtedness amount.

(o) *Fraud.* Notwithstanding any other provision of this section, a mortgage credit certificate does not meet the requirements of this section and, therefore, the certificate is not a qualified mortgage credit certificate for any calendar year, if the holder of the certificate provides a certification or any other information to the lender providing the mortgage or to the issuer of the certificate containing a material misstatement and such misstatement is due to fraud. In determining whether any misstatement is due to fraud, the rules generally applicable to underpayments of tax due to fraud (including rules relating to the statute of limitations) shall apply. See §1.6709–1T with respect to the penalty for filing negligent or fraudulent statements.

[T.D. 8023, 50 FR 19348, May 8, 1985, as amended at T.D. 8502, 58 FR 67689, Dec. 22, 1993; T.D. 8692, 61 FR 66215, Dec. 17, 1996]

§1.25–4T Qualified mortgage credit certificate program (Temporary).

(a) *In general*—(1) *Definition of qualified mortgage credit certificate program.* For purposes of §§1.25–1T through 1.25–8T, the term ''qualified mortgage credit certificate program'' means a program to issue qualified mortgage credit certificates which meets all of the requirements of paragraphs (b) through (i) of this section.

(2) *Requirements are a minimum.* Except as otherwise provided in this section, the requirements of this section are minimum requirements. Issuers may establish more stringent criteria for participation in a qualified mortgage credit certificate program. Thus,

for example, an issuer may target 30 percent of the proceeds of an issue of mortgage credit certificates to targeted areas. Further, issuers may establish additional eligibility criteria for participation in a qualified mortgage credit certificate program. Thus, for example, issuers may impose an income limitation designed to ensure that only those individuals who could not otherwise purchase a residence will benefit from the credit.

(3) Except as otherwise provided in this section and §1.25–3T, issuers may use mortgage credit certificates in connection with other Federal, State, and local programs provided that such use complies with the requirements of §1.25–3T(j). Thus, for example, a mortgage credit certificate may be issued in connection with the qualified rehabilitation of a residence part of the cost of which will be paid from the proceeds of a State grant.

(b) *Establishment of program.* A program meets the requirements of this paragraph only if it is established by a State or political subdivision thereof for any calendar year for which it has the authority to issue qualified mortgage bonds.

(c) *Election not to issue qualified mortgage bonds*—(1) *In general.* A program meets the requirements of this paragraph only if the issuer elects, in the time and manner specified in this paragraph, not to issue an amount of qualified mortgage bonds that it may otherwise issue during the calendar year under section 103A and the regulations thereunder.

(2) *Manner of making election.* On or before the earlier of the date of distribution of mortgage credit certificates under a program or December 31, 1987, the issuer must file an election not to issue an amount of qualified mortgage bonds. The election (and the certification (or affidavit) described in paragraph (d)) shall be filed with the Internal Revenue Service Center, Philadelphia, Pennsylvania 19255. The election should be titled ''Mortgage Credit Certificate Election'' and must include—

(i) The name, address, and TIN of the issuer,

(ii) The issuer's applicable limit, as defined in section 103A (g) and the regulations thereunder,

(iii) The aggregate amount of qualified mortgage bonds issued by the issuing authority during the calendar year,

(iv) The amount of the issuer's applicable limit that it has surrendered to other issuers during the calendar year,

(v) The date and amount of any previous elections under this paragraph for the calendar year, and

(vi) The amount of qualfied mortgage bonds that the issuer elects not to issue.

(3) *Revocation of election.* Any election made under this paragraph may be revoked, in whole or in part, at any time during the calendar year in which the election was made. The revocation, however, may not be made with respect to any part of the nonissued bond amount that has been used to issue mortgage credit certificates pursuant to the election. The revocation shall be filed with the Internal Revenue Service Center, Philadelphia, Pennsylvania 19255. The revocation should be titled ''Revocation of Mortgage Credit Certificate Election'' and must include—

(i) The name, address, and TIN of the issuer,

(ii) The nonissued bond amount as originally elected, and

(iii) The portion of the nonissued bond amount with respect to which the election is being revoked.

(4) *Special rule.* If at the time that an issuer makes an election under this paragraph it does not know its applicable limit, the issuer may elect not to use all of its remaining authority to issue qualified mortgage bonds; this form of election will be treated as meeting the requirements of paragraph (c)(2) if, prior to the later of the end of the calendar year and December 31, 1985, the issuer amends its election so as to indicate the exact amount of qualified mortgage bond authority that it elected not to issue.

(5) *Limitation on nonissued bond amount.* The amount of qualified mortgage bonds which an issuer elects not to issue may not exceed the issuer's applicable limit (as determined under section 103A (g) and the regulations

thereunder). For example, a governmental unit that, pursuant to section 103A (g)(3), may issue $10 million of qualified mortgage bonds that elects to trade in $11 million in qualified mortgage bond authority has not met the requirements of this paragraph, and mortgage credit certificates issued pursuant to such election are not qualified mortgage credit certificates.

(d) *State certification requirement*—(1) *In general.* A program meets the requirements of this paragraph only if the State official designated by law (or, where there is no State official, the Governor) certifies, based on facts and circumstances as of the date on which the certification is requested, following a request for such certification, that the issue meets the requirements of section 103A(g) (relating to volume limitation) and the regulations thereunder. A copy of the State certification must be attached to the issuer's election not to issue qualified mortgage bonds, except that, in the case of elections made during calendar year 1984, the certification may be filed with the Service prior to July 8, 1985 provided that mortgage credit certificates may not be distributed until the certification is filed. In the case of any constitutional home rule city, the certification shall be made by the chief executive officer of the city.

(2) *Certification procedure.* The official making the certification described in this paragraph (d) need not perform an independent investigation to determine whether the issuer has met the requirements of section 103A(g). In determining the aggregate amount of qualified mortgage bonds previously issued by that issuer during the calendar year the official may rely on copies of prior elections under paragraph (c) of this section made by the issuer for that year, together with an affidavit executed by an official of the issuer who is responsible for issuing bonds stating that the issuer has not, to date, issued any other issues of qualified mortgage bonds during the calendar year and stating the amount, if any, of the issuer's applicable limit that it has surrendered to other issuers during the calendar year; for any calendar year prior to 1985, the official may rely on an affidavit executed by a duly authorized official of the issuer who states the aggregate amount of qualified mortgage bonds issued by the issuer during the year. In determining the aggregate amount of qualified mortgage bonds that the issuer has previously elected not to issue during that calendar year, the official may rely on copies of any elections not to issue qualified mortgage bonds filed by the issuer for that calendar year, together with an affidavit executed by an official of the issuer responsible for issuing mortgage credit certificates stating that the issuer has not, to date, made any other elections not to issue qualified mortgage bonds. If, based on such information, the certifying official determines that the issuer has not, as of the date on which the certification is provided, exceeded its applicable limit for the year, the official may certify that the issue meets the requirements of section 103A(g). The fact that the certification described in this paragraph (d) is provided does not ensure that the issuer has met the requirements of section 103A(g) and the regulations thereunder, nor does it preclude the application of the penalty for overissuance of mortgage credit certificates if such over-issuance actually occurs. See §1.25–5T.

(3) *Special rule.* If within 30 days after the issuer files a proper request for the certification described in this paragraph (d) the issuer has not received from the State official designated by law (or, if there is no State official, the Governor) certification that the issue meets the requirements of section 103A(g) or, in the alternative, a statement that the issue does not meet such requirements, the issuer may submit, in lieu of the certification required by this paragraph (d), an affidavit executed by an officer of the issuer responsible for issuing mortgage credit certificates stating that—

(i) The issue meets the requirements of section 103A(g) and the regulations thereunder,

(ii) At least 30 days before the execution of the affidavit the issuer filed a proper request for the certification described in this paragraph (d), and

(iii) The State official designated by law (or, if there is no State official, the

Governor) has not provided the certification described in this paragraph (d) or a statement that the issue does not meet such requirements.

For purposes of this paragraph, a request for certification is proper if the request includes the reports and affidavits described in paragraph (d)(2).

(e) *Information reporting requirement*—(1) *Reports*. With respect to mortgage credit certificates issued after September 30, 1985, a program meets the requirements of this paragraph only if the issuer submits a report containing the information concerning the holders of certificates issued during the preceding reporting period required by this paragraph. The report must be filed for each reporting period in which certificates (other than transferred certificates) are issued under the program. The issuer is not responsible for false information provided by a holder if the issuer did not know or have reason to know that the information was false. The report must be filed on the form prescribed by the Internal Revenue Service. If no form is prescribed, or if the form prescribed is not readily available, the issuer may use its own form provided that such form is in the format set forth in this paragraph and contains the information required by this paragraph. The report must be titled ''Mortgage Credit Certificate Information Report'' and must include the name, address, and TIN of the issuer, the reporting period for which the information is provided, and the following tables containing information concerning the holders of certificates issued during the reporting period for which the report is filed:

(i) A table titled ''Number of Mortgage Credit Certificates by Income and Acquisition Cost'' showing the number of mortgage credit certificates issued (other than those issued in connection with qualified home improvement and rehabilitation loans) according to the annualized gross income of the holders (categorized in the following intervals of income:

$0–$9,999;
$10,000–$19,999;
$20,000–$29,999;
$30,000–$39,999;
$40,000–$49,999;
$50,000–$74,999; and
$75,000 or more)

and according to the acquisition cost of the residences acquired in connection with the mortgage credit certificates (categorized in the following intervals of acquisition cost:

$0–$19,999;
$20,000–$39,999;
$40,000–$59,999;
$60,000–$79,999;
$80,000–$99,999;
$100,000–$119,999;
$120,000–$149,999;
$150,000–$199,999; and
$200,000 or more).

For each interval of income and acquisition cost the table must also be categorized according to—

(A) The aggregate amount of fees charged to holders to cover any administrative costs incurred by the issuer in issuing mortgage credit certificates, and

(B) The number of holders that—

(*1*) Did not have a present ownership interest in a principal residence at any time during the 3-year period ending on the date the mortgage credit certificate is executed (*i.e.*, satisfied the 3-year requirement) and purchased residences in targeted areas,

(*2*) Satisfied the 3-year requirement and purchased residences not located in targeted areas,

(*3*) Did have a present ownership interest in a principal residence at any time during the 3-year period ending on the date the mortgage credit certificate is executed (*i.e.*, did not satisfy the 3-year requirement) and purchased residences in targeted areas, and

(*4*) Did not satisfy the 3-year requirement and purchased residences not located in targeted areas.

(ii) A table titled ''Volume of Mortgage Credit Certificates by Income and Acquisition Cost'' containing data on—

(A) The total of the certified indebtedness amounts of the certificates issued (other than those issued in connection with qualified home improvement and rehabilitation loans);

(B) The sum of the products of the certified indebtedness amount and the certificate credit rate for each certificate (other than those issued in connection with qualified home improvement and rehabilitation loans) according to annualized gross income (categorized in the same intervals of income as the preceding table) and according to the acquisition cost of the residences acquired in connection with mortgage credit certificates (categorized in the same intervals of acquisition cost as the preceding table); and

(C) For each interval of income and acquisition cost, the information described in paragraph (e)(1)(ii) (A) and (B) categorized according to the holders that—

(*1*) Satisfied the 3-year requirement and purchased residences in targeted areas,

(*2*) Satisfied the 3-year requirement and purchased residences not located in targeted areas,

(*3*) Did not satisfy the 3-year requirement and purchased residences in targeted areas, and

(*4*) Did not satisfy the 3-year requirement and purchased residences not located in targeted areas.

(iii) A table titled ''Mortgage Credit Certificates for Qualified Home Improvement and Rehabilitation Loans'' showing the number of mortgage credit certificates issued in connection with qualified home improvement loans and qualified rehabilitation loans, the total of the certified indebtedness amount with respect to such certificates, and the sum of the products of the certified indebtedness amount and the certificate credit rate for each certificate; the information contained in the table must also be categorized according to whether the residences with respect to which the certificates were provided are located in targeted areas.

(2) *Format.* If no form is prescribed by the Internal Revenue Service, or if the prescribed form is not readily available, the issuer must submit the report in the format specified in this paragraph (e)(2). The specified format of the report is the following:

MORTGAGE CREDIT CERTIFICATE INFORMATION REPORT

Name of issuer:
Address of issuer:
TIN of issuer:
Reporting period:

NUMBER OF MORTGAGE CREDIT CERTIFICATES BY INCOME AND ACQUISITION COST

3-year requirement: Annualized gross monthly income of borrowers	Satisfied		Not satisfied		Totals fees
	Nontargeted area	Targeted area	Nontargeted area	Targeted area	
$0 to $9,999.					
$10,000 to $19,999.					
$20,000 to $29,999.					
$30,000 to $39,999.					
$40,000 to $49,999.					
$50,000 to $74,999.					
$75,000 or more.					
Total.					
Acquisition Cost					
0 to $19,999.					
$20,000 to $39,999.					
$40,000 to $59,999.					
$60,000 to $79,999.					
$80,000 to $99,999.					
$100,000 to $119,999.					
$120,000 to $149,999.					
$150,000 to $199,999.					
$200,000 or more.					
Total.					

VOLUME OF MORTGAGE CREDIT CERTIFICATES BY INCOME AND ACQUISITION COST

Annualized gross monthly income of holders	Holders satisfying the 3-year requirement				3-year requirement not satisfied				Totals	
	Nontargeted area		Targeted area		Nontargeted area		Targeted area			
	Total of the certified indebtedness amounts	Sum of products of certified indebtedness amounts and credit rates	Total of the certified indebtedness amounts	Sum of products of certified indebtedness amounts and credit rates	Total of the certified indebtedness amounts	Sum of products of certified indebtedness amounts and credit rates	Total of the certified indebtedness amounts	Sum of products of certified indebtedness amounts and credit rates	Total of the certified indebtedness amounts	Total sum of products of certified indebtedness amounts and credit rates
$0 to $9,999.										
$10,000 to $19,999.										
$20,000 to $29,999.										
$30,000 to $39,999.										
$40,000 to $49,999.										
$50,000 to $74,999.										
$75,000 to more.										
Total.										
Acquisition Cost										
$0 to $19,999.										
$20,000 to $39,999.										
$40,000 to $59,999.										
$60,000 to $79,999.										
$80,000 to $99,999.										
$100,000 to $119,999.										
$120,000 to $149,999.										
$150,000 to $199,999.										
$200,000 or more.										
Total.										

MORTGAGE CREDIT CERTIFICATES FOR QUALIFIED HOME IMPROVEMENT AND REHABILITATION LOANS

	Nontargeted area	Targeted area	Totals
Home Improvement Loans			
Number of mortgage credit certificates.			
Total of the certified indebtedness amounts.			
Product of certified indebtedness amounts and credit rates.			
Rehabilitation Loans			
Number of mortgage credit certificates.			
Total of the certified indebtedness amounts.			
Product of certified indebtedness amounts and credit rates.			

(3) *Definitions and special rules.* (i) For purposes of this paragraph the term ''annualized gross income'' means the borrower's gross monthly income multiplied by 12. Gross monthly income is the sum of monthly gross pay, any additional income from investments, pensions, Veterans Administration (VA) compensation, part-time employment, bonuses, dividends, interest, current overtime pay, net rental income, etc., and other income (such as alimony and child support, if the borrower chooses to disclose such income). Information with respect to gross monthly income may be obtained from available loan documents, e.g., the sum of lines 23D and 23E on the Application for VA or FmHA Home Loan Guaranty or for HUD/FHA Insured Mortgage (VA Form 26–1802a, HUD 92900, Jan. 1982), or the total line from the Gross Monthly Income section of FHLMC Residential Loan Application form (FHLMC 65 Rev. 8/78).

(ii) For purposes of this paragraph, the term ''reporting period'' means each one year period beginning July 1 and ending June 30, except that issuers need not provide data with respect to the period prior to October 1, 1985.

(iii) For purposes of this paragraph, verification of information concerning a holder's gross monthly income by utilizing other available information concerning the holder's income (e.g., Federal income tax returns) is not required. In determining whether the holder of a mortgage credit certificate acquiring a residence in a targeted area satisfies the 3-year requirement, the issuer may rely on a statement signed by the holder.

(4) *Time for filing.* The report required by this paragraph shall be filed not later than the 15th day of the second calendar month after the close of the reporting period. The Commissioner may grant an extension of time for the filing of a report required by this paragraph if there is reasonable cause for the failure to file such report in a timely fashion. The report may be filed at any time before such date but must be complete based on facts and reasonable expectations as of the date the report is filed. The report need not be amended to reflect information learned subsequent to the date of filing, or to reflect changed circumstances with respect to any holder.

(5) *Place for filing.* The report required by this paragraph is to be filed at the Internal Revenue Service Center, Philadelphia, Pennsylvania 19255.

(f) *Policy statement.* A program established pursuant to an election under paragraph (c) made after 1984 meets the requirements of this paragraph only if the applicable elected representative of the governmental unit—

(1) Which is the issuer, or

(2) On whose behalf the certificates were issued,

has published (after a public hearing following reasonable public notice) a policy statement described in §1.103A–2(1) by the last day of the year preceding the year in which the election under paragraph (c) is made, and a copy of such report has been submitted to the Commissioner on or before such last day. See §1.103A–2(1) for further definitions and requirements.

(g) *Targeted areas requirement*—(1) *In general.* A program meets the requirements of this paragraph only if—

(i) The portion of the total proceeds of the issue specified in paragraph (g)(2) is made available to provide mortgage credit certificates in connection with owner financing of targeted area residents for at least 1 year after the date on which mortgage credit certificates are first made available with respect to targeted area residences, and

(ii) The issuer attempts with reasonable diligence to place such proceeds with qualified persons.

Mortgage credit certificates are considered first made available with respect to targeted area residences on the date on which the issuer first begins to accept applications for mortgage credit certificates provided under that issue.

(2) *Specified portion.* (i) The specified portion of the total proceeds of an issue is the lesser of—

(A) 20 percent of the total proceeds, or

(B) 8 percent of the average annual aggregate principal amount of mortgages executed during the immediately preceding 3 calendar years for single-family, owner-occupied residences in targeted areas within the jurisdiction of the issuing authority.

For purposes of computing the required portion of the total proceeds specified in paragraph (g)(2)(i)(B) where such provision is applicable, an issuer may rely upon the safe-harbor formula provided in the regulations under section 103A(h).

(ii) See §1.25–1T(b)(10)(ii) for the definition of ''total proceeds''.

(h) *Fees*—(1) *In general.* A program meets the requirements of this paragraph only if each applicant is required to pay, directly or indirectly, no fee other than those fees permitted under this paragraph.

(2) *Permissible fees.* Applicants may be required to pay the following fees provided that they are reasonable:

(i) Points, origination fees, servicing fees, and other fees in amounts that are customarily charged with respect to mortgages not provided in connection with mortgage credit certificates,

(ii) Application fees, survey fees, credit report fees, insurance fees, or similar settlement or financing costs to the extent such amounts do not exceed the amounts charged in the area in cases where mortgages are not provided in connection with mortgage credit certificates. For example, amounts charged for FHA, VA, or similar private mortgage insurance on an individual's mortgage are permissible so long as such amounts do not exceed the amounts charged in the area with respect to a similar mortgage that is not provided in connection with a mortgage credit certificate, and

(iii) Other fees that, taking into account all the facts and circumstances, are reasonably necessary to cover any administrative costs incurred by the issuer or its agent in issuing mortgage credit certificates.

(i) *Qualified mortgage credit certificate.* A program meets the requirements of this paragraph only if each mortgage credit certificate issued under the program meets each of the requirements of paragraphs (c) through (o) of §1.25–3T.

(j) *Good faith compliance efforts*—(1) *Eligibility requirements.* (i) A program under which each of the mortgage credit certificates issued does not meet each of the requirements of paragraphs (c) through (o) of §1.25–3T shall be treated as meeting the requirements of paragraph (i) of this section if each of the requirements of this paragraph (j)(1) is satisfied. A mortgage credit certificate program meets the requirements of this paragraph (j)(1) only if each of the following provisions is met:

(A) The issuer in good faith attempted to issue mortgage credit certificates only to individuals meeting each of the requirements of paragraphs (c) through (o) of §1.25–3T. Good faith requires that agreements with lenders and agents and other relevant instruments contain restrictions that permit the approval of mortgage credit certificates only in accordance with the requirements of paragraphs (c) through (o) of §1.25–3T. In addition, the issuer must establish reasonable procedures to ensure compliance with those requirements. Reasonable procedures include reasonable investigations by the issuer to determine whether individuals satisfy the requirements of paragraphs (c) through (o) of §1.25–3T.

(B) 95 percent or more of the total proceeds of the issue were devoted to individuals with respect to whom, at the time that the certificate was issued, all the requirements of paragraphs (c) through (o) of §1.25–3T were met. If a holder of a mortgage credit certificate fails to meet more than one of these requirements, the amount of the certificate (*i.e.*, the certificate credit rate multiplied by the certified indebtedness amount) issued to that individual will be taken into account only once in determining whether the 95-percent requirement is met. However, all of the defects in that individual's certificate must be corrected pursuant to paragraph (j)(1)(i)(C).

(C) Any failure to meet the requirements of paragraphs (c) through (o) of §1.25–3T is corrected within a reasonable period after that failure is discovered. For example, if an individual fails to meet one or more of such requirements those failures can be corrected by revoking that individual's certificate.

(ii) *Examples.* The following examples illustrate the application of this paragraph (j)(1):

Example 1. County X only distributes mortgage credit certificates to individuals who have contracted to purchase a principal residence. County X requires that applicants for mortgage credit certificates present the following information:

(i) An affidavit stating that the applicant intends to use the residence in connection with which the mortgage credit certificate is issued as his principal residence within a reasonable time after the certificate is issued by County X, that the applicant will notify the County if the residence ceases to be his principal residence, and facts that are sufficient for County X to determine whether the residence is located within the jurisdiction of County X,

(ii) An affidavit stating that the applicant had no present ownership interest in a principal residence at any time during the 3-year period prior to the date on which the certificate is issued,

(iii) Copies of the applicant's Federal tax returns for the preceding 3 years,

(iv) Affidavits from the seller of the residence with respect to which the certificate is issued and the applicant stating the purchase price of the residence, including an itemized list of (A) payments made by or for the benefit of the applicant, (B) if the residence is incomplete, an estimate of the reasonable cost of completing the residence, and (C) if the residence is subject to a ground rent, the capitalized value of the ground rent,

(v) An affidavit executed by the applicant stating that the mortgage being acquired in connection with the certificate will not be used to acquire or replace an existing mortgage,

(vi) An affidavit executed by the applicant stating that no portion of the financing for the residence in connection with which the certificate is issued is provided from the proceeds of a qualified mortgage bond or qualified veterans' mortgage bond and that no portion of the mortgage for the residence is provided by a person related to the applicant (as defined in §1.25–3T(n)),

(vii) An affidavit executed by the applicant stating that the certificate was not limited to indebtedness incurred from particular lenders, and

(viii) In the case of a mortgate credit certificate allocated for use in connection with a particular development, and affidavit executed by the applicant stating that the applicant received from the developer a certification stating that the price of the residence with respect to which the certificate was issued is no higher than it would be without the use of a mortgage credit certificate.

County X examines the information submitted by the applicant to determine whether the requirements of paragraphs (c), (d), (e), (f), (g), (i), (j), (k), and (n) of §1.25–3T are met. County X determines that the certificate has not expired. The mortgage credit certificates issued by County X are in the form prescribed by §1.25–6T and County X provides all the required information and statements. After determining that the applicant meets all these requirements County X issues a mortgage credit certificate to the applicant. This procedure for issuing mortgage credit certificates is sufficient evidence of the good faith of County X to meet the requirements of §1.25–4T(j)(1)(i)(A).

Example 2. County W distributes preliminary mortgage credit certificates to individuals who have not entered into contracts to purchase a principal residence. County W issues preliminary certificates in the form prescribed by §1.25–6T to those applicants that have submitted statements that they (i) intend to purchase a single-family residence located within the jurisdiction of County W which they will occupy as a principal residence, (ii) have had no present ownership interest in a principal residence within the preceding 3-year period, and (iii) will not use the certificate in connection with the acquisition or replacement of an existing mortgage. The certificates contain a maximum purchase price, the certificate credit rate, and a statement that the certificate will expire if the applicant does not enter into a closing agreement with respect to a loan within 6 months from the date of preliminary issuance. Holders of these certificates may apply for a mortgage loan from any lender. When the holder of the certificate applies for a loan the lender requires that he submit the following:

(i) An affidavit stating that the applicant intends to use the residence in connection with which the mortgage credit certificate is issued as his principal residence within a reasonable time after the certificate is issued by County W, that the applicant will notify the County if the residence ceases to be his principal residence, and facts that are sufficient for County W to determine whether the residence is located within the jurisdication of County W,

(ii) An affidavit stating that the applicant had no present ownership interest in a principal residence at any time during the 3-year period prior to the date on which the certificate is issued,

(iii) Copies of the applicant's Federal tax returns for the preceding 3 years,

(iv) Affidavits from the seller of the residence with respect to which the certificate is issued and the applicant stating the purchase price of the residence, including an itemized list of (A) payments made by or for the benefit of the applicant, (B) if the residence is incomplete, an estimate of the reasonable cost of completing the residence, and (C) if the residence is subject to a ground rent, the capitalized value of the ground rent,

(v) An affidavit executed by the applicant stating that the mortgage being acquired in connection with the certificate will not be used to acquire or replace an existing mortgage,

(vi) An affidavit executed by the applicant stating that no portion of the financing for the residence in connection with which the certificate is issued in provided from the proceeds of a qualified mortgage bond or qualified veterans' mortgage bond and that no portion of the mortgage for the residence is provided by a person related to the applicant (as defined in §1.25–3T(n)),

(vii) An affidavit executed by the applicant stating that the certificate was not limited to indebtedness incurred from particular lenders, and

(viii) In the case of a mortgage credit certificate allocated for use in connection with a particular development, an affidavit executed by the applicant stating that the applicant received from the developer a certification stating that the price of the residence with respect to which the certificate was issued is no higher than it would be without the use of a mortgage credit certificate.

The lender then submits those affidavits, together with its statement as to the amount of the indebtedness incurred, to County W. After determining that the requirements of paragraphs (c), (d), (e), (f), (g), (i), (j), (k) and (n) of §1.25–3T are met and determining that the certificate has not expired, County W completes the mortgage credit certificate. This procedure for issuing mortgage credit certificates is sufficient evidence of the good faith of County W to meet the requirements of §1.25–4T(j)(1)(i)(A).

(2) *Program requirements*. (i) A mortgage credit certificate program which fails to meet one or more of the requirements of paragraphs (b) through (h) of this section shall be treated as meeting such requirements if the requirements of this paragraph (j)(2) are satisfied. A mortgage credit certificate program meets the requirements of this paragraph (j)(2) only if each of the following provisions is met:

(A) The issuer in good faith attempted to meet all of the requirements of paragraphs (b) through (h) of this section. This good faith requirement will be met if all reasonable steps are taken by the issuer to ensure that the program complies with these requirements.

(B) Any failure to meet such requirements is due to inadvertent error, e.g., mathematical error, after taking reasonable steps to comply with such requirements.

(ii) The following example illustrate the application of this paragraph (j)(2):

Example. City X issues an issue of mortgage credit certificates. However, despite taking all reasonable steps to determine accurately the size of the applicable limit, as provided in section 103A (g)(3) and the regulations thereunder, the limit is exceeded because the amount of the mortgages, originated in the area during the past 3 years is incorrectly computed as a result of mathematical error. Such facts are sufficient evidence of the good faith of the issuer to meet the requirements of paragraph (j)(2).

[T.D. 8023, 50 FR 19350, May 8, 1985, as amended by T.D. 8048, 50 FR 35538, Sept. 3, 1985]

§ 1.25–5T Limitation on aggregate amount of mortgage credit certificates (Temporary).

(a) *In general*. If the aggregate amount of qualified mortgage credit certificates (as defined in paragraph (b)) issued by an issuer under a qualified mortgage credit certificate program exceeds 20 percent of the nonissued bond amount (as defined in paragraph (c)), the provisions of paragraph (d) shall apply.

(b) *Aggregate amount of mortgage credit certificates*—(1) *In general*. The aggregate amount of qualified mortgage credit certificates issued under a qualified mortgage credit certificate program is the sum of the products determined by multiplying—

(i) The certified indebtedness amount of each qualified mortgage credit certificate issued under that program, by

(ii) The certificate credit rate with respect to such certificate.

(2) *Examples.* The following examples illustrate the application of this paragraph (b):

Example 1. For 1986 City Q has a nonissued bond amount of $100 million. After making a proper election, Q issues 2,000 qualified mortgage credit certificates each with a certificate credit rate of 20 percent and a certified indebtedness amount of $50,000. The aggregate amount of qualified mortgage credit certificates is $20 million (2,000 × (.2 × $50,000)). Since this amount does not exceed 20 percent of the nonissued bond amount (.2 × $100 million = $20 million), Q has complied with the limitation on the aggregate amount of mortgage credit certificates, provided that it does not issue any additional certificates.

Example 2. The facts are the same as in example (1) except that instead of issuing all its certificates at the 20 percent rate, Q issues (i) qualified mortgage credit certificates with a certificate credit rate of 10 percent and an aggregate principal amount of $25 million, (ii) qualified mortgage credit certificates with a certificate credit rate of 40 percent and an aggregate principal amount of $25 million, and (iii) qualified mortgage credit certificates with a certificate credit rate of 30 percent and an aggregate principal amount of $25 million. The aggregate amount of qualified mortgage credit certificates is $20 million ((10 percent of $25 million) plus (40 percent of $25 million) plus (30 percent of $25 million)). Q has complied with the limitation on the aggregate amount of qualified mortgage credit certificates, provided that it does not issue any additional certificates pursuant to the same program.

(c) *Nonissued bond amount.* The term ''nonissued bond amount'' means, with respect to any qualified mortgage credit certificate program, the amount of qualified mortgage bonds (as defined in section 103A(c)(1) and the regulations thereunder) which the issuer is otherwise authorized to issue and elects not to issue under section 25(c)(2) and §1.25–4T(b). The amount of qualified mortgage bonds which an issuing authority is authorized to issue is determined under section 103A(g) and the regulations thereunder; such determination shall take into account any prior elections by the issuer not to issue qualified mortgage bonds, the amount of any reduction in the State ceiling under paragraph (d) of this section, and the aggregate amount of qualified mortgage bonds issued by the issuer prior to its election not to issue qualified mortgage bonds.

(d) *Noncompliance with limitation on aggregate amount of mortgage credit certificates*—(1) *In general.* If the provisions of this paragraph apply, the State ceiling under section 103A(g)(4) and the regulations thereunder for the calendar year following the calendar year in which the Commissioner determines the correction amount for the State in which the issuer which exceeded the limitation on the aggregate amount of mortgage credit certificates is located shall be reduced by 1.25 times the correction amount with respect to such failure.

(2) *Correction amount.* (i) The term ''correction amount'' means an amount equal to the excess credit amount divided by .20.

(ii) The term ''excess credit amount'' means the excess of—

(A) The credit amount for any mortgage credit certificate program, over

(B) The amount which would have been the credit amount for such program had such program met the requirements of section 25(d)(2) and paragraph (a) of this section.

(iii) The term ''credit amount'' means the sum of the products determined by multiplying—

(A) The certified indebtedness amount of each qualified mortgage credit certificate issued under the program, by

(B) The certificate credit rate with respect to such certificate.

(3) *Example.* The following example illustrates the application of this paragraph:

Example. For 1987 City R has a nonissued bond amount of $100 million. City R issues all of its mortgage credit certificates with a certificate credit rate of 20 percent. City R issues certificates with an aggregate certified indebtedness amount of $120 million. The aggregate amount of mortgage credit certificates issued by City R is $24 million, which exceeds 20 percent of the nonissued bond amount. The State ceiling for the calendar year following the calendar year in which the Commissioner determines the correction amount is reduced by $25 million (the correction amount multiplied by 1.25). The correction amount is determined as follows: The credit amount is $24 million (.2 × $120 million); the amount which would have been the credit amount for the program had it met the requirements of section 25(d)(2) is $20 million (.2 × $100 million); the excess credit amount is $4 million ($24 million—$20 million); therefore, the correction amount is $20 million ($4 million/.2).

(4) *Cross-references.* See section 103A(g)(4) and the regulations thereunder with respect to the reduction of the applicable State ceiling.

[T.D. 8023, 50 FR 19353, May 8, 1985]

§ 1.25–6T Form of qualified mortgage credit certificate (Temporary).

(a) *In general.* Qualified mortgage credit certificates are to be issued on the form prescribed by the Internal Revenue Service. If no form is prescribed by the Internal Revenue Service, or if the form prescribed by the Internal Revenue Service is not readily available, the issuer may use its own form provided that such form contains the information required by this section. Each mortgage credit certificate must be issued in a form such that there are at least three copies of the form. One copy of the certificate shall be retained by the issuer; one copy shall be retained by the lender; and one copy shall be forwarded to the State official who issued the certification required by § 1.25–4T(d), unless that State official has stated in writing that he does not want to receive such copies.

(b) *Required information.* Each qualified mortgage credit certificate must include the following information:

(1) The name, address, and TIN of the issuer,

(2) The date of the issuer's election not to issue qualified mortgage bonds pursuant to which the certificate is being issued,

(3) The number assigned to the certificate,

(4) The name, address, and TIN of the holder of the certificate,

(5) The certificate credit rate,

(6) The certified indebtness amount,

(7) The acquisition cost of the residence being acquired in connection with the certificate,

(8) The average area purchase price applicable to the residence,

(9) Whether the certificate meets the requirements of § 1.25–3T(d), relating to residence requirement,

(10) Whether the certificate meets the requirements of § 1.25–3T(e), relating to 3-year requirement,

(11) Whether the certificate meets the requirements of § 1.25–3T(g), relating to new mortgage requirement,

(12) Whether the certificate meets the requirements of § 1.25–3T(i), relating to prohibited mortgages,

(13) Whether the certificate meets the requirements of § 1.25–3T(j), relating to particular lenders,

(14) Whether the certificate meets the requirements of § 1.25–3T(k), relating to allocations to particular developments,

(15) Whether the certificate meets the requirements of § 1.25–3T(n), relating to interest paid to related persons,

(16) Whether the residence in connection with which the certificate is issued is a targeted area residence,

(17) The date on which a closing agreement is signed with respect to the certified indebtness amount,

(18) The expiration date of the certificate,

(19) A statement that the certificate is not transferable or a statement that the certificate may be transferred only if the issuer issues a new certificate, and

(20) A statement, signed under penalties of perjury by an authorized official of the issuer or its agent, that such person has made the determinations specified in paragraph (b) (9) through (16).

[T.D. 8023, 50 FR 19354, May 8, 1985]

§ 1.25–7T Public notice (Temporary).

(a) *In general.* At least 90 days prior to the issuance of any mortgage credit certificate under a qualified mortgage credit certificate program, the issuer shall provide reasonable public notice of—

(1) The eligibility requirements for such certificate,

(2) The methods by which such certificates are to be issued, and

(3) The other information required by this section.

(b) *Reasonable public notice*—(1) *In general.* Reasonable public notice means published notice which is reasonably designed to inform individuals who would be eligible to receive mortgage credit certificates of the proposed issuance. Reasonable public notice may be provided through newspapers of general circulation.

(2) *Contents of notice.* The public notice required by paragraph (a) must include a brief description of the principal residence requirement, 3-year requirement, purchase price requirement, and new mortgage requirement. The notice must also provide a brief description of the methods by which the certificates are to be issued and the address and telephone number for obtaining further information.

[T.D. 8023, 50 FR 19354, May 8, 1985]

§ 1.25–8T Reporting requirements (Temporary).

(a) *Lender*—(1) *In general.* Each person who makes a loan that is a certified indebtedness amount with respect to any mortgage credit certificate must file the report described in paragraph (a)(2) and must retain on its books and records the information described in paragraph (a)(3). The report described in paragraph (a)(2) is an annual report and must be filed on or before January 31 of the year following the calendar year to which the report relates. See section 6709(c) and the regulations thereunder for the applicable penalties with respect to failure to file reports.

(2) *Information required.* The report shall be submitted on Form 8329 and shall contain the information required therein. A separate Form 8329 shall be filed for each issue of mortgage credit certificates with respect to which the lender made mortgage loans during the preceding calendar year. Thus, for example, if during 1986 Bank M makes three mortgage loans which are certified indebtedness amounts with respect to State Z's January 15, 1986, issue of mortgage credit certificates, and two mortgage loans which are certified indebtedness amounts with respect to State Z's April 15, 1986, issue of mortgage credit certificates, and fifty mortgage loans which are certified indebtedness amounts with respect to County X's December 31, 1985, issue of mortgage credit certificates, Bank M must file three separate reports for calendar year 1986. The lender must submit the Form 8329 with the information required therein, including—

(i) The name, address, and TIN of the issuer of the mortgage credit certificates,

(ii) The date on which the election not to issue qualified mortgage bonds with respect to that mortgage credit certificate was made,

(iii) The name, address, and TIN of the lender, and

(iv) The sum of the products determined by multiplying—

(A) The certified indebtedness amount of each mortgage credit certificate issued under such program, by

(B) The certificate credit rate with respect to such certificate.

(3) *Recordkeeping requirements.* Each person who makes a loan that is a certified indebtedness amount with respect to any mortgage credit certificate must retain the information specified in this paragraph (a)(3) on its books and records for 6 years following the year in which the loan was made. With respect to each loan the lender must retain the following information:

(i) The name, address, and TIN of each holder of a qualified mortgage credit certificate with respect to which a loan is made,

(ii) The name, address, and TIN of the issuer of such certificate, and

(iii) The date the loan for the certified indebtedness amount is closed, the certified indebtedness amount, and the certificate credit rate of such certificate.

(b) *Issuers*—(1) *In general.* Each issuer of mortgage credit certificates shall file the report described in paragraph (b)(2) of this section.

(2) *Quarterly reports.* (i) Each issuer which elects to issue mortgage credit certificates shall file reports on Form 8330. These reports shall be filed on a quarterly basis, beginning with the quarter in which the election is made, and are due on the following dates: April 30 (for the quarter ending March 31), July 31 (for the quarter ending June 30), October 31 (for the quarter ending September 30), and January 31 (for the quarter ending December 31). For elections made prior to May 8, 1985, the first report need not be filed until July 31, 1985. An issuer shall file a separate report for each issue of mortgage credit certificates. In the quarter in which the last qualified mortgage credit certificate that may be issued under a program is issued, the issuer must state that fact on the report to be filed

for that quarter; the issuer is not required to file any subsequent reports with respect to that program. See section 6709(c) for the penalties with respect to failure to file a report.

(ii) The report shall be submitted on Form 8330 and shall contain the information required therein, including—

(A) The name, address, and TIN of the issuer of the mortgage credit certificates,

(B) The date of the issuer's election not to issue qualified mortgage bonds with respect to the mortgage credit certificate program and the nonissued bond amount of the program,

(C) The sum of the products determined by multiplying—

(*1*) The certified indebtedness amount of each qualified mortgage credit certificate issued under that program during the calendar quarter, by

(*2*) The certificate credit rate with respect to such certificate, and

(D) A listing of the name, address, and TIN of each holder of a qualified mortgage credit certificate which has been revoked during the calendar quarter.

(c) *Extensions of time for filing reports.* The Commissioner may grant an extension of time for the filing of a report required by this section if there is reasonable cause for the failure to file such report in a timely fashion.

(d) *Place for filing.* The reports required by this section are to be filed at the Internal Revenue Service Center, Philadelphia, Pennsylvania 19225.

(e) *Cross reference.* See section 6709 and the regulations thereunder with respect to the penalty for failure to file a report required by this section.

[T.D. 8023, 50 FR 19354, May 8, 1985]

§ 1.25A–0 Table of contents.

This section lists captions contained in §§ 1.25A–1, 1.25A–2, 1.25A–3, 1.25A–4, and 1.25A–5.

(c) Both degree and nondegree courses are eligible for the credit.
(1) In general.
(2) Examples.
(d) Effective date.

§ 1.25A–5 Special Rules Relating to Characterization and Timing of Payments

(a) Educational expenses paid by claimed dependent.
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(f) Refund of qualified tuition and related expenses.
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(6) Examples.

[T.D. 9034, 67 FR 78691, Dec. 26, 2002]

§ 1.25A–1 Calculation of education tax credit and general eligibility requirements.

(a) *Amount of education tax credit.* An individual taxpayer is allowed a nonrefundable education tax credit against income tax imposed by chapter 1 of the Internal Revenue Code for the taxable year. The amount of the education tax credit is the total of the Hope Scholarship Credit (as described in §1.25A–3) plus the Lifetime Learning Credit (as described in §1.25A–4). For limitations on the credits allowed by subpart A of part IV of subchapter A of chapter 1 of the Internal Revenue Code, see section 26.

(b) *Coordination of Hope Scholarship Credit and Lifetime Learning Credit*—(1) *In general.* In the same taxable year, a taxpayer may claim a Hope Scholarship Credit for each eligible student's qualified tuition and related expenses (as defined in §1.25A–2(d)) and a Lifetime Learning Credit for one or more other students' qualified tuition and related expenses. However, a taxpayer may not claim both a Hope Scholarship Credit and a Lifetime Learning Credit with respect to the same student in the same taxable year.

(2) *Hope Scholarship Credit.* Subject to certain limitations, a Hope Scholarship Credit may be claimed for the qualified tuition and related expenses paid during a taxable year with respect to each eligible student (as defined in §1.25A–3(d)). Qualified tuition and related expenses paid during a taxable year with respect to one student may not be taken into account in computing the amount of the Hope Scholarship Credit with respect to any other student. In addition, qualified tuition and related expenses paid during a taxable year with respect to any student for whom a Hope Scholarship Credit is claimed may not be taken into account in computing the amount of the Lifetime Learning Credit.

(3) *Lifetime Learning Credit.* Subject to certain limitations, a Lifetime Learning Credit may be claimed for the aggregate amount of qualified tuition and related expenses paid during a taxable year with respect to students for whom no Hope Scholarship Credit is claimed.

(4) *Examples.* The following examples illustrate the rules of this paragraph (b):

Example 1. In 1999, Taxpayer A pays qualified tuition and related expenses for his dependent, B, to attend College Y during 1999. Assuming all other relevant requirements are met, Taxpayer A may claim either a

Hope Scholarship Credit or a Lifetime Learning Credit with respect to dependent B, but not both. See §1.25A–3(a) and §1.25A–4(a).

Example 2. In 1999, Taxpayer C pays $2,000 in qualified tuition and related expenses for her dependent, D, to attend College Z during 1999. In 1999, Taxpayer C also pays $500 in qualified tuition and related expenses to attend a computer course during 1999 to improve Taxpayer C's job skills. Assuming all other relevant requirements are met, Taxpayer C may claim a Hope Scholarship Credit for the $2,000 of qualified tuition and related expenses attributable to dependent D (see §1.25A–3(a)) and a Lifetime Learning Credit (see §1.25A–4(a)) for the $500 of qualified tuition and related expenses incurred to improve her job skills.

Example 3. The facts are the same as in *Example 2,* except that Taxpayer C pays $3,000 in qualified tuition and related expenses for her dependent, D, to attend College Z during 1999. Although a Hope Scholarship Credit is available only with respect to the first $2,000 of qualified tuition and related expenses paid with respect to D (see §1.25A–3(a)), Taxpayer C may not add the $1,000 of excess expenses to her $500 of qualified tuition and related expenses in computing the amount of the Lifetime Learning Credit.

(c) *Limitation based on modified adjusted gross income*—(1) *In general.* The education tax credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified adjusted gross income between $40,000 and $50,000 ($80,000 and $100,000 for married individuals who file a joint return). Thus, taxpayers with modified adjusted gross income above $50,000 (or $100,000 for joint filers) may not claim an education tax credit.

(2) *Modified adjusted gross income defined.* The term *modified adjusted gross income* means the adjusted gross income (as defined in section 62) of the taxpayer for the taxable year increased by any amount excluded from gross income under section 911, 931, or 933 (relating to income earned abroad or from certain U.S. possessions or Puerto Rico).

(3) *Inflation adjustment.* For taxable years beginning after 2001, the amounts in paragraph (c)(1) of this section will be increased for inflation occurring after 2000 in accordance with section 1(f)(3). If any amount adjusted under this paragraph (c)(3) is not a multiple of $1,000, the amount will be rounded to the next lowest multiple of $1,000.

(d) *Election.* No education tax credit is allowed unless a taxpayer elects to claim the credit on the taxpayer's federal income tax return for the taxable year in which the credit is claimed. The election is made by attaching Form 8863, ''Education Credits (Hope and Lifetime Learning Credits),'' to the federal income tax return.

(e) *Identification requirement.* No education tax credit is allowed unless a taxpayer includes on the federal income tax return claiming the credit the name and the taxpayer identification number of the student for whom the credit is claimed. For rules relating to assessment for an omission of a correct taxpayer identification number, see section 6213(b) and (g)(2)(J).

(f) *Claiming the credit in the case of a dependent*—(1) *In general.* If a student is a claimed dependent of another taxpayer, only that taxpayer may claim the education tax credit for the student's qualified tuition and related expenses. However, if another taxpayer is eligible to, but does not, claim the student as a dependent, only the student may claim the education tax credit for the student's qualified tuition and related expenses.

(2) *Examples.* The following examples illustrate the rules of this paragraph (f):

Example 1. In 1999, Taxpayer A pays qualified tuition and related expenses for his dependent, B, to attend University Y during 1999. Taxpayer A claims B as a dependent on his federal income tax return. Therefore, assuming all other relevant requirements are met, Taxpayer A is allowed an education tax credit on his federal income tax return, and B is not allowed an education tax credit on B's federal income tax return. The result would be the same if B paid the qualified tuition and related expenses. See §1.25A–5(a).

Example 2. In 1999, Taxpayer C has one dependent, D. In 1999, D pays qualified tuition and related expenses to attend University Z during 1999. Although Taxpayer C is eligible to claim D as a dependent on her federal income tax return, she does not do so. Therefore, assuming all other relevant requirements are met, D is allowed an education tax credit on D's federal income tax return, and Taxpayer C is not allowed an education tax credit on her federal income tax return, with respect to D's education expenses. The result would be the same if C paid the qualified tuition and related expenses on behalf of D. See §1.25A–5(b).

(g) *Married taxpayers.* If a taxpayer is married (within the meaning of section 7703), no education tax credit is allowed to the taxpayer unless the taxpayer and the taxpayer's spouse file a joint Federal income tax return for the taxable year.

(h) *Nonresident alien taxpayers and dependents.* If a taxpayer or the taxpayer's spouse is a nonresident alien for any portion of the taxable year, no education tax credit is allowed unless the nonresident alien is treated as a resident alien by reason of an election under section 6013(g) or (h). In addition, if a student is a nonresident alien, a taxpayer may not claim an education tax credit with respect to the qualified tuition and related expenses of the student unless the student is a claimed dependent (as defined in §1.25A–2(a)).

[T.D. 9034, 67 FR 78691, Dec. 26, 2002]

§ 1.25A–2 Definitions.

(a) *Claimed dependent.* A *claimed dependent* means a dependent (as defined in section 152) for whom a deduction under section 151 is allowed on a taxpayer's federal income tax return for the taxable year. Among other requirements under section 152, a nonresident alien student must be a resident of a country contiguous to the United States in order to be treated as a dependent.

(b) *Eligible educational institution*—(1) *In general.* In general, an *eligible educational institution* means a college, university, vocational school, or other postsecondary educational institution that is—

(i) Described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088) as in effect on August 5, 1997, (generally all accredited public, nonprofit, and proprietary postsecondary institutions); and

(ii) Participating in a Federal financial aid program under title IV of the Higher Education Act of 1965 or is certified by the Department of Education as eligible to participate in such a program but chooses not to participate.

(2) *Rules on Federal financial aid programs.* For rules governing an educational institution's eligibility to participate in Federal financial aid programs, see 20 U.S.C. 1070; 20 U.S.C. 1094; and 34 CFR 600 and 668.

(c) *Academic period. Academic period* means a quarter, semester, trimester, or other period of study as reasonably determined by an eligible educational institution. In the case of an eligible educational institution that uses credit hours or clock hours, and does not have academic terms, each payment period (as defined in 34 CFR 668.4, revised as of July 1, 2002) may be treated as an academic period.

(d) *Qualified tuition and related expenses*—(1) *In general. Qualified tuition and related expenses* means tuition and fees required for the enrollment or attendance of a student for courses of instruction at an eligible educational institution.

(2) *Required fees*—(i) *In general.* Except as provided in paragraph (d)(3) of this section, the test for determining whether any fee is a qualified tuition and related expense is whether the fee is required to be paid to the eligible educational institution as a condition of the student's enrollment or attendance at the institution.

(ii) *Books, supplies, and equipment.* Qualified tuition and related expenses include fees for books, supplies, and equipment used in a course of study only if the fees must be paid to the eligible educational institution for the enrollment or attendance of the student at the institution.

(iii) *Nonacademic fees.* Except as provided in paragraph (d)(3) of this section, qualified tuition and related expenses include fees charged by an eligible educational institution that are not used directly for, or allocated to, an academic course of instruction only if the fee must be paid to the eligible educational institution for the enrollment or attendance of the student at the institution.

(3) *Personal expenses.* Qualified tuition and related expenses do not include the costs of room and board, insurance, medical expenses (including student health fees), transportation, and similar personal, living, or family expenses, regardless of whether the fee must be paid to the eligible educational institution for the enrollment or attendance of the student at the institution.

(4) *Treatment of a comprehensive or bundled fee.* If a student is required to

pay a fee (such as a comprehensive fee or a bundled fee) to an eligible educational institution that combines charges for qualified tuition and related expenses with charges for personal expenses described in paragraph (d)(3) of this section, the portion of the fee that is allocable to personal expenses is not included in qualified tuition and related expenses. The determination of what portion of the fee relates to qualified tuition and related expenses and what portion relates to personal expenses must be made by the institution using a reasonable method of allocation.

(5) *Hobby courses*. Qualified tuition and related expenses do not include expenses that relate to any course of instruction or other education that involves sports, games, or hobbies, or any noncredit course, unless the course or other education is part of the student's degree program, or in the case of the Lifetime Learning Credit, the student takes the course to acquire or improve job skills.

(6) *Examples*. The following examples illustrate the rules of this paragraph (d). In each example, assume that the institution is an eligible educational institution and that all other relevant requirements to claim an education tax credit are met. The examples are as follows:

Example 1. University V offers a degree program in dentistry. In addition to tuition, all students enrolled in the program are required to pay a fee to University V for the rental of dental equipment. Because the equipment rental fee must be paid to University V for enrollment and attendance, the tuition and the equipment rental fee are qualified tuition and related expenses.

Example 2. First-year students at College W are required to obtain books and other reading materials used in its mandatory first-year curriculum. The books and other reading materials are not required to be purchased from College W and may be borrowed from other students or purchased from off-campus bookstores, as well as from College W's bookstore. College W bills students for any books and materials purchased from College W's bookstore. The fee that College W charges for the first-year books and materials purchased at its bookstore is not a qualified tuition and related expense because the books and materials are not required to be purchased from College W for enrollment or attendance at the institution.

Example 3. All students who attend College X are required to pay a separate student activity fee in addition to their tuition. The student activity fee is used solely to fund on-campus organizations and activities run by students, such as the student newspaper and the student government (no portion of the fee covers personal expenses). Although labeled as a student activity fee, the fee is required for enrollment or attendance at College X. Therefore, the fee is a qualified tuition and related expense.

Example 4. The facts are the same as in *Example 3*, except that College X offers an optional athletic fee that students may pay to receive discounted tickets to sports events. The athletic fee is not required for enrollment or attendance at College X. Therefore, the fee is not a qualified tuition and related expense.

Example 5. College Y requires all students to live on campus. It charges a single comprehensive fee to cover tuition, required fees, and room and board. Based on College Y's reasonable allocation, sixty percent of the comprehensive fee is allocable to tuition and other required fees not allocable to personal expenses, and the remaining forty percent of the comprehensive fee is allocable to charges for room and board and other personal expenses. Therefore, only sixty percent of College Y's comprehensive fee is a qualified tuition and related expense.

Example 6. As a degree student at College Z, Student A is required to take a certain number of courses outside of her chosen major in Economics. To fulfill this requirement, Student A enrolls in a square dancing class offered by the Physical Education Department. Because Student A receives credit toward her degree program for the square dancing class, the tuition for the square dancing class is included in qualified tuition and related expenses.

[T.D. 9034, 67 FR 78691, Dec. 26, 2002]

§ 1.25A–3 Hope Scholarship Credit.

(a) *Amount of the credit*—(1) *In general*. Subject to the phaseout of the education tax credit described in § 1.25A–1(c), the Hope Scholarship Credit amount is the total of—

(i) 100 percent of the first $1,000 of qualified tuition and related expenses paid during the taxable year for education furnished to an eligible student (as defined in paragraph (d) of this section) who is the taxpayer, the taxpayer's spouse, or any claimed dependent during any academic period beginning in the taxable year (or treated as beginning in the taxable year, see § 1.25A–5(e)(2)); plus

(ii) 50 percent of the next $1,000 of such expenses paid with respect to that student.

(2) *Maximum credit*. For taxable years beginning before 2002, the maximum Hope Scholarship Credit allowed for each eligible student is $1,500. For taxable years beginning after 2001, the amounts used in paragraph (a)(1) of this section to determine the maximum credit will be increased for inflation occurring after 2000 in accordance with section 1(f)(3). If any amount adjusted under this paragraph (a)(2) is not a multiple of $100, the amount will be rounded to the next lowest multiple of $100.

(b) *Per student credit*—(1) *In general*. A Hope Scholarship Credit may be claimed for the qualified tuition and related expenses of each eligible student (as defined in paragraph (d) of this section).

(2) *Example*. The following example illustrates the rule of this paragraph (b). In the example, assume that all the requirements to claim an education tax credit are met. The example is as follows:

Example. In 1999, Taxpayer A has two dependents, B and C, both of whom are eligible students. Taxpayer A pays $1,600 in qualified tuition and related expenses for dependent B to attend a community college. Taxpayer A pays $5,000 in qualified tuition and related expenses for dependent C to attend University X. Taxpayer A may claim a Hope Scholarship Credit of $1,300 ($1,000 + (.50 × $600)) for dependent B, and the maximum $1,500 Hope Scholarship Credit for dependent C, for a total Hope Scholarship Credit of $2,800.

(c) *Credit allowed for only two taxable years*. For each eligible student, the Hope Scholarship Credit may be claimed for no more than two taxable years.

(d) *Eligible student*—(1) *Eligible student defined*. For purposes of the Hope Scholarship Credit, the term *eligible student* means a student who satisfies all of the following requirements—

(i) *Degree requirement*. For at least one academic period that begins during the taxable year, the student enrolls at an eligible educational institution in a program leading toward a postsecondary degree, certificate, or other recognized postsecondary educational credential;

(ii) *Work load requirement*. For at least one academic period that begins during the taxable year, the student enrolls for at least one-half of the normal full-time work load for the course of study the student is pursuing. The standard for what is half of the normal full-time work load is determined by each eligible educational institution. However, the standard for half-time may not be lower than the applicable standard for half-time established by the Department of Education under the Higher Education Act of 1965 and set forth in 34 CFR 674.2(b) (revised as of July 1, 2002) for a half-time undergraduate student;

(iii) *Year of study requirement*. As of the beginning of the taxable year, the student has not completed the first two years of postsecondary education at an eligible educational institution. Whether a student has completed the first two years of postsecondary education at an eligible educational institution as of the beginning of a taxable year is determined based on whether the institution in which the student is enrolled in a degree program (as described in paragraph (d)(1)(i) of this section) awards the student two years of academic credit at that institution for postsecondary course work completed by the student prior to the beginning of the taxable year. Any academic credit awarded by the eligible educational institution solely on the basis of the student's performance on proficiency examinations is disregarded in determining whether the student has completed two years of postsecondary education; and

(iv) *No felony drug conviction*. The student has not been convicted of a Federal or State felony offense for possession or distribution of a controlled substance as of the end of the taxable year for which the credit is claimed.

(2) *Examples*. The following examples illustrate the rules of this paragraph (d). In each example, assume that the student has not been convicted of a felony drug offense, that the institution is an eligible educational institution unless otherwise stated, that the qualified tuition and related expenses are paid during the same taxable year that the academic period begins, and that a

Hope Scholarship Credit has not previously been claimed for the student (see paragraph (c) of this section). The examples are as follows:

Example 1. Student A graduates from high school in June 1998 and is enrolled in an undergraduate degree program at College U for the 1998 Fall semester on a full-time basis. For the 1999 Spring semester, Student A again is enrolled at College U on a full-time basis. For the 1999 Fall semester, Student A is enrolled in less than half the normal full-time course work for her degree program. Because Student A is enrolled in an undergraduate degree program on at least a half-time basis for at least one academic period that begins during 1998 and at least one academic period that begins during 1999, Student A is an eligible student for taxable years 1998 and 1999 (including the 1999 Fall semester when Student A enrolls at College U on less than a half-time basis).

Example 2. Prior to 1998, Student B attended college for several years on a full-time basis. Student B transfers to College V for the 1998 Spring semester. College V awards Student B credit for some (but not all) of the courses he previously completed, and College V classifies Student B as a first-semester sophomore. During both the Spring and Fall semesters of 1998, Student B is enrolled in at least one-half the normal full-time work load for his degree program at College V. Because College V does not classify Student B as having completed the first two years of postsecondary education as of the beginning of 1998, Student B is an eligible student for taxable year 1998.

Example 3. The facts are the same as in *Example 2.* After taking classes on a half-time basis for the 1998 Spring and Fall semesters, Student B is enrolled at College V for the 1999 Spring semester on a full-time basis. College V classifies Student B as a second-semester sophomore for the 1999 Spring semester and as a first-semester junior for the 1999 Fall semester. Because College V does not classify Student B as having completed the first two years of postsecondary education as of the beginning of 1999, Student B is an eligible student for taxable year 1999. Therefore, the qualified expenses and required fees paid for the 1999 Spring semester and the 1999 Fall semester are taken into account in calculating any Hope Scholarship Credit.

Example 4. Prior to 1998, Student C was not enrolled at another eligible educational institution. At the time that Student C enrolls in a degree program at College W for the 1998 Fall semester, Student C takes examinations to demonstrate her proficiency in several subjects. On the basis of Student C's performance on these examinations, College W classifies Student C as a second-semester sophomore as of the beginning of the 1998 Fall semester. Student C is enrolled at College W during the 1998 Fall semester and during the 1999 Spring and Fall semesters on a full-time basis and is classified as a first-semester junior as of the beginning of the 1999 Spring semester. Because Student C was not enrolled in a college or other eligible educational institution prior to 1998 (but rather was awarded three semesters of academic credit solely because of proficiency examinations), Student C is not treated as having completed the first two years of postsecondary education at an eligible educational institution as of the beginning of 1998 or as of the beginning of 1999. Therefore, Student C is an eligible student for both taxable years 1998 and 1999.

Example 5. During the 1998 Fall semester, Student D is a high school student who takes classes on a half-time basis at College X. Student D is not enrolled as part of a degree program at College X because College X does not admit students to a degree program unless the student has a high school diploma or equivalent. Because Student D is not enrolled in a degree program at College X during 1998, Student D is not an eligible student for taxable year 1998.

Example 6. The facts are the same as in *Example 5.* In addition, during the 1999 Spring semester, Student D again attends College X but not as part of a degree program. Student D graduates from high school in June 1999. For the 1999 Fall semester, Student D enrolls in College X as part of a degree program, and College X awards Student D credit for her prior course work at College X. During the 1999 Fall semester, Student D is enrolled in more than one-half the normal full-time work load of courses for her degree program at College X. Because Student D is enrolled in a degree program at College X for the 1999 Fall term on at least a half-time basis, Student D is an eligible student for all of taxable year 1999. Therefore, the qualified tuition and required fees paid for classes taken at College X during both the 1999 Spring semester (during which Student D was not enrolled in a degree program) and the 1999 Fall semester are taken into account in computing any Hope Scholarship Credit.

Example 7. Student E completed two years of undergraduate study at College S. College S is not an eligible educational institution for purposes of the education tax credit. At the end of 1998, Student E enrolls in an undergraduate degree program at College Z, an eligible educational institution, for the 1999 Spring semester on a full-time basis. College Z awards Student E two years of academic credit for his previous course work at College S and classifies Student E as a first-semester junior for the 1999 Spring semester. Student E is treated as having completed the first two years of postsecondary education at an eligible educational institution as of the beginning of 1999. Therefore, Student E is not an eligible student for taxable year 1999.

Example 8. Student F received a degree in 1998 from College R. College R is not an eligible educational institution for purposes of the education tax credit. During 1999, Student F is enrolled in a graduate-degree program at College Y, an eligible educational institution, for the 1999 Fall semester on a full-time basis. By admitting Student F to its graduate degree program, College Y treats Student F as having completed the first two years of postsecondary education as of the beginning of 1999. Therefore, Student F is not an eligible student for taxable year 1999.

Example 9. Student G graduates from high school in June 2001. In January 2002, Student G is enrolled in a one-year postsecondary certificate program on a full-time basis to obtain a certificate as a travel agent. Student G completes the program in December 2002 and is awarded a certificate. In January 2003, Student G enrolls in a one-year postsecondary certificate program on a full-time basis to obtain a certificate as a computer programer. Student G meets the degree requirement, the work load requirement, and the year of study requirement for the taxable years 2002 and 2003. Therefore, Student G is an eligible student for both taxable years 2002 and 2003.

(e) *Academic period for prepayments*—(1) *In general.* For purposes of determining whether a student meets the requirements in paragraph (d) of this section for a taxable year, if qualified tuition and related expenses are paid during one taxable year for an academic period that begins during January, February or March of the next taxable year (for taxpayers on a fiscal taxable year, use the first three months of the next taxable year), the academic period is treated as beginning during the taxable year in which the payment is made.

(2) *Example.* The following example illustrates the rule of this paragraph (e). In the example, assume that all the requirements to claim a Hope Scholarship Credit are met. The example is as follows:

Example. Student G graduates from high school in June 1998. After graduation, Student G works full-time for several months to earn money for college. Student G is enrolled on a full-time basis in an undergraduate degree program at University W, an eligible educational institution, for the 1999 Spring semester, which begins in January 1999. Student G pays tuition to University W for the 1999 Spring semester in December 1998. Because the tuition paid by Student G in 1998 relates to an academic period that begins during the first three months of 1999, Student G's eligibility to claim a Hope Scholarship Credit in 1998 is determined as if the 1999 Spring semester began in 1998. Thus, assuming Student G has not been convicted of a felony drug offense as of December 31, 1998, Student G is an eligible student for 1998.

(f) *Effective date.* The Hope Scholarship Credit is applicable for qualified tuition and related expenses paid after December 31, 1997, for education furnished in academic periods beginning after December 31, 1997.

[T.D. 9034, 67 FR 78691, Dec. 26, 2002; 68 FR 15940, Apr. 2, 2003]

§ 1.25A–4 Lifetime Learning Credit.

(a) *Amount of the credit*—(1) *Taxable years beginning before January 1, 2003.* Subject to the phaseout of the education tax credit described in § 1.25A–1(c), for taxable years beginning before 2003, the Lifetime Learning Credit amount is 20 percent of up to $5,000 of qualified tuition and related expenses paid during the taxable year for education furnished to the taxpayer, the taxpayer's spouse, and any claimed dependent during any academic period beginning in the taxable year (or treated as beginning in the taxable year, see § 1.25A–5(e)(2)).

(2) *Taxable years beginning after December 31, 2002.* Subject to the phaseout of the education tax credit described in § 1.25A–1(c), for taxable years beginning after 2002, the Lifetime Learning Credit amount is 20 percent of up to $10,000 of qualified tuition and related expenses paid during the taxable year for education furnished to the taxpayer, the taxpayer's spouse, and any claimed dependent during any academic period beginning in the taxable year (or treated as beginning in the taxable year, see § 1.25A–5(e)(2)).

(3) *Coordination with the Hope Scholarship Credit.* Expenses paid with respect to a student for whom the Hope Scholarship Credit is claimed are not eligible for the Lifetime Learning Credit.

(4) *Examples.* The following examples illustrate the rules of this paragraph (a). In each example, assume that all the requirements to claim a Lifetime Learning Credit or a Hope Scholarship Credit, as applicable, are met. The examples are as follows:

Example 1. In 1999, Taxpayer A pays qualified tuition and related expenses of $3,000 for dependent B to attend an eligible educational institution, and Taxpayer A pays qualified tuition and related expenses of $4,000 for dependent C to attend an eligible educational institution. Taxpayer A does not claim a Hope Scholarship Credit with respect to either B or C. Although Taxpayer A paid $7,000 of qualified tuition and related expenses during the taxable year, Taxpayer A may claim the Lifetime Learning Credit with respect to only $5,000 of such expenses. Therefore, the maximum Lifetime Learning Credit Taxpayer A may claim for 1999 is $1,000 (.20 × $5,000).

Example 2. In 1999, Taxpayer D pays $6,000 of qualified tuition and related expenses for dependent E, and $2,000 of qualified tuition and related expenses for dependent F, to attend eligible educational institutions. Dependent F has already completed the first two years of postsecondary education. For 1999, Taxpayer D claims the maximum $1,500 Hope Scholarship Credit with respect to dependent E. In computing the amount of the Lifetime Learning Credit, Taxpayer D may not include any of the $6,000 of qualified tuition and related expenses paid on behalf of dependent E but may include the $2,000 of qualified tuition and related expenses of dependent F.

(b) *Credit allowed for unlimited number of taxable years.* There is no limit to the number of taxable years that a taxpayer may claim a Lifetime Learning Credit with respect to any student.

(c) *Both degree and nondegree courses are eligible for the credit*—(1) *In general.* For purposes of the Lifetime Learning Credit, amounts paid for a course at an eligible educational institution are qualified tuition and related expenses if the course is either part of a postsecondary degree program or is not part of a postsecondary degree program but is taken by the student to acquire or improve job skills.

(2) *Examples.* The following examples illustrate the rule of this paragraph (c). In each example, assume that all the requirements to claim a Lifetime Learning Credit are met. The examples are as follows:

Example 1. Taxpayer A, a professional photographer, enrolls in an advanced photography course at a local community college. Although the course is not part of a degree program, Taxpayer A enrolls in the course to improve her job skills. The course fee paid by Taxpayer A is a qualified tuition and related expense for purposes of the Lifetime Learning Credit.

Example 2. Taxpayer B, a stockbroker, plans to travel abroad on a ''photo-safari'' for his next vacation. In preparation for the trip, Taxpayer B enrolls in a noncredit photography class at a local community college. Because Taxpayer B is not taking the photography course as part of a degree program or to acquire or improve his job skills, amounts paid by Taxpayer B for the course are not qualified tuition and related expenses for purposes of the Lifetime Learning Credit.

(d) *Effective date.* The Lifetime Learning Credit is applicable for qualified tuition and related expenses paid after June 30, 1998, for education furnished in academic periods beginning after June 30, 1998.

[T.D. 9034, 67 FR 78691, Dec. 26, 2002]

§ 1.25A–5 Special rules relating to characterization and timing of payments.

(a) *Educational expenses paid by claimed dependent.* For any taxable year for which the student is a claimed dependent of another taxpayer, qualified tuition and related expenses paid by the student are treated as paid by the taxpayer to whom the deduction under section 151 is allowed.

(b) *Educational expenses paid by a third party*—(1) *In general.* Solely for purposes of section 25A, if a third party (someone other than the taxpayer, the taxpayer's spouse if the taxpayer is treated as married within the meaning of section 7703, or a claimed dependent) makes a payment directly to an eligible educational institution to pay for a student's qualified tuition and related expenses, the student is treated as receiving the payment from the third party and, in turn, paying the qualified tuition and related expenses to the institution.

(2) *Special rule for tuition reduction included in gross income of employee.* Solely for purposes of section 25A, if an eligible educational institution provides a reduction in tuition to an employee of the institution (or to the spouse or dependent child of an employee, as described in section 132(h)(2)) and the amount of the tuition reduction is included in the employee's gross income, the employee is treated as receiving payment of an amount equal to the tuition reduction and, in turn, paying such amount to the institution.

(3) *Examples.* The following examples illustrate the rules of this paragraph (b). In each example, assume that all the requirements to claim an education tax credit are met. The examples are as follows:

Example 1. Grandparent D makes a direct payment to an eligible educational institution for Student E's qualified tuition and related expenses. Student E is not a claimed dependent in 1999. For purposes of claiming an education tax credit, Student E is treated as receiving the money from her grandparent and, in turn, paying her qualified tuition and related expenses.

Example 2. Under a court-approved divorce decree, Parent A is required to pay Student C's college tuition. Parent A makes a direct payment to an eligible educational institution for Student C's 1999 tuition. Under paragraph (b)(1) of this section, Student C is treated as receiving the money from Parent A and, in turn, paying the qualified tuition and related expenses. Under the divorce decree, Parent B has custody of Student C for 1999. Parent B properly claims Student C as a dependent on Parent B's 1999 federal income tax return. Under paragraph (a) of this section, expenses paid by Student C are treated as paid by Parent B. Thus, Parent B may claim an education tax credit for the qualified tuition and related expenses paid directly to the institution by Parent A.

Example 3. University A, an eligible educational institution, offers reduced tuition charges to its employees and their dependent children. F is an employee of University A. F's dependent child, G, enrolls in a graduate-level course at University A. Section 117(d) does not apply, because it is limited to tuition reductions provided for education below the graduate level. Therefore, the amount of the tuition reduction received by G is treated as additional compensation from University A to F and is included in F's gross income. For purposes of claiming a Lifetime Learning Credit, F is treated as receiving payment of an amount equal to the tuition reduction from University A and, in turn, paying such amount to University A on behalf of F's child, G.

(c) *Adjustment to qualified tuition and related expenses for certain excludable educational assistance*—(1) *In general.* In determining the amount of an education tax credit, qualified tuition and related expenses for any academic period must be reduced by the amount of any tax-free educational assistance allocable to such period. For this purpose, *tax-free educational assistance* means—

(i) A qualified scholarship that is excludable from income under section 117;

(ii) A veterans' or member of the armed forces' educational assistance allowance under chapter 30, 31, 32, 34 or 35 of title 38, United States Code, or under chapter 1606 of title 10, United States Code;

(iii) Employer-provided educational assistance that is excludable from income under section 127; or

(iv) Any other educational assistance that is excludable from gross income (other than as a gift, bequest, devise, or inheritance within the meaning of section 102(a)).

(2) *No adjustment for excludable educational assistance attributable to expenses paid in a prior year.* A reduction is not required under paragraph (c)(1) of this section if the amount of excludable educational assistance received during the taxable year is treated as a refund of qualified tuition and related expenses paid in a prior taxable year. See paragraph (f)(5) of this section.

(3) *Scholarships and fellowship grants.* For purposes of paragraph (c)(1)(i) of this section, a scholarship or fellowship grant is treated as a qualified scholarship excludable under section 117 except to the extent—

(i) The scholarship or fellowship grant (or any portion thereof) may be applied, by its terms, to expenses other than qualified tuition and related expenses within the meaning of section 117(b)(2) (such as room and board) and the student reports the grant (or the appropriate portion thereof) as income on the student's federal income tax return if the student is required to file a return; or

(ii) The scholarship or fellowship grant (or any portion thereof) must be applied, by its terms, to expenses other than qualified tuition and related expenses within the meaning of section 117(b)(2) (such as room and board) and the student reports the grant (or the appropriate portion thereof) as income on the student's federal income tax return if the student is required to file a return.

(4) *Examples.* The following examples illustrate the rules of this paragraph (c). In each example, assume that all the requirements to claim an education

tax credit are met. The examples are as follows:

Example 1. University X charges Student A, who lives on University X's campus, $3,000 for tuition and $5,000 for room and board. University X awards Student A a $2,000 scholarship. The terms of the scholarship permit it to be used to pay any of a student's costs of attendance at University X, including tuition, room and board, and other incidental expenses. University X applies the $2,000 scholarship against Student A's $8,000 total bill, and Student A pays the $6,000 balance of her bill from University X with a combination of savings and amounts she earns from a summer job. University X does not require A to pay any additional fees beyond the $3,000 in tuition in order to enroll in or attend classes. Student A does not report any portion of the scholarship as income on her federal income tax return. Since Student A does not report the scholarship as income, the scholarship is treated under paragraph (c)(3) of this section as a qualified scholarship that is excludable under section 117. Therefore, for purposes of calculating an education tax credit, Student A is treated as having paid only $1,000 ($3,000 tuition − $2,000 scholarship) in qualified tuition and related expenses to University X.

Example 2. The facts are the same as in *Example 1,* except that Student A reports the entire scholarship as income on the student's federal income tax return. Since the full amount of the scholarship may be applied to expenses other than qualified expenses (room and board) and Student A reports the scholarship as income, the exception in paragraph (c)(3) of this section applies and the scholarship is not treated as a qualified scholarship excludable under section 117. Therefore, for purposes of calculating an education tax credit, Student A is treated as having paid $3,000 of qualified tuition and related expenses to University X.

Example 3. The facts are the same as in *Example 1,* except that the terms of the scholarship require it to be used to pay tuition. Under paragraph (c)(3) of this section, the scholarship is treated as a qualified scholarship excludable under section 117. Therefore, for purposes of calculating an education tax credit, Student A is treated as having paid only $1,000 ($3,000 tuition − $2,000 scholarship) in qualified tuition and related expenses to University X.

Example 4. The facts are the same as in *Example 1,* except that the terms of the scholarship require it to be used to pay tuition or room and board charged by University X, and the scholarship amount is $6,000. Under the terms of the scholarship, Student A may allocate the scholarship between tuition and room and board in any manner. However, because room and board totals $5,000, that is the maximum amount that can be applied under the terms of the scholarship to expenses other than qualified expenses and at least $1,000 of the scholarship must be applied to tuition. Therefore, the maximum amount of the exception under paragraph (c)(3) of this section is $5,000 and at least $1,000 is treated as a qualified scholarship excludable under section 117 ($6,000 scholarship − $5,000 room and board). If Student A reports $5,000 of the scholarship as income on the student's federal income tax return, then Student A will be treated as having paid $2,000 ($3,000 tuition − $1,000 qualified scholarship excludable under section 117) in qualified tuition and related expenses to University X.

Example 5. The facts are the same as in *Example 1,* except that in addition to the scholarship that University X awards to Student A, University X also provides Student A with an education loan and pays Student A for working in a work/study job in the campus dining hall. The loan is not excludable educational assistance within the meaning of paragraph (c) of this section. In addition, wages paid to a student who is performing services for the payor are neither a qualified scholarship nor otherwise excludable from gross income. Therefore, Student A is not required to reduce her qualified tuition and related expenses by the amounts she receives from the student loan or as wages from her work/study job.

Example 6. In 1999, Student B pays University Y $1,000 in tuition for the 1999 Spring semester. University Y does not require Student B to pay any additional fees beyond the $1,000 in tuition in order to enroll in classes. Student B is an employee of Company Z. At the end of the academic period and during the same taxable year that Student B paid tuition to University Y, Student B provides Company Z with proof that he has satisfactorily completed his courses at University Y. Pursuant to an educational assistance program described in section 127(b), Company Z reimburses Student B for all of the tuition paid to University Y. Because the reimbursement from Company Z is employer-provided educational assistance that is excludable from Student B's gross income under section 127, the reimbursement reduces Student B's qualified tuition and related expenses. Therefore, for purposes of calculating an education tax credit, Student B is treated as having paid no qualified tuition and related expenses to University Y during 1999.

Example 7. The facts are the same as in *Example 6* except that the reimbursement from Company Z is not pursuant to an educational assistance program described in section 127(b), is not otherwise excludable from Student B's gross income, and is taxed as additional compensation to Student B. Because the reimbursement is not excludable educational assistance within the meaning of paragraph (c)(1) of this section, Student B is not required to reduce his qualified tuition and related expenses by the $1,000 reimbursement he received from his employer. Therefore, for purposes of calculating an education tax credit, Student B is treated as paying $1,000 in qualified tuition and related expenses to University Y during 1999.

(d) *No double benefit.* Qualified tuition and related expenses do not include any expense for which a deduction is allowed under section 162, section 222, or any other provision of chapter 1 of the Internal Revenue Code.

(e) *Timing rules*—(1) *In general.* Except as provided in paragraph (e)(2) of this section, an education tax credit is allowed only for payments of qualified tuition and related expenses for an academic period beginning in the same taxable year as the year the payment is made. Except for certain individuals who do not use the cash receipts and disbursements method of accounting, qualified tuition and related expenses are treated as paid in the year in which the expenses are actually paid. See §1.461–1(a)(1).

(2) *Prepayment rule*—(i) *In general.* If qualified tuition and related expenses are paid during one taxable year for an academic period that begins during the first three months of the taxpayer's next taxable year (*i.e.*, in January, February, or March of the next taxable year for calendar year taxpayers), an education tax credit is allowed with respect to the qualified tuition and related expenses only in the taxable year in which the expenses are paid.

(ii) *Example.* The following example illustrates the rule of this paragraph (e)(2). In the example, assume that all the requirements to claim an education tax credit are met. The example is as follows:

Example. In December 1998, Taxpayer A, a calendar year taxpayer, pays College Z $1,000 in qualified tuition and related expenses to attend classes during the 1999 Spring semester, which begins in January 1999. Taxpayer A may claim an education tax credit only in 1998 for payments made in 1998 for the 1999 Spring semester.

(3) *Expenses paid with loan proceeds.* An education tax credit may be claimed for qualified tuition and related expenses paid with the proceeds of a loan only in the taxable year in which the expenses are paid, and may not be claimed in the taxable year in which the loan is repaid. Loan proceeds disbursed directly to an eligible educational institution will be treated as paid on the date the institution credits the proceeds to the student's account. For example, in the case of any loan issued or guaranteed as part of a Federal student loan program under title IV of the Higher Education Act of 1965, loan proceeds will be treated as paid on the date of disbursement (as defined in 34 CFR 668.164(a), revised as of July 1, 2002) by the eligible educational institution. If a taxpayer does not know the date the institution credits the student's account, the taxpayer must treat the qualified tuition and related expenses as paid on the last date for payment prescribed by the institution.

(4) *Expenses paid through third party installment payment plans*—(i) *In general.* A taxpayer, an eligible educational institution, and a third party installment payment company may enter into an agreement in which the company agrees to collect installment payments of qualified tuition and related expenses from the taxpayer and to remit the installment payments to the institution. If the third party installment payment company is the taxpayer's agent for purposes of paying qualified tuition and related expenses to the eligible educational institution, the taxpayer is treated as paying the qualified expenses on the date the company pays the institution. However, if the third party installment payment company is the eligible educational institution's agent for purposes of collecting payments of qualified tuition and related expenses from the taxpayer, the taxpayer is treated as paying the qualified expenses on the date the taxpayer pays the company.

(ii) *Example.* The following example illustrates the rule of this paragraph (e)(4). The example is as follows:

Example. Student A, Company B, and College C enter into a written agreement in which Student A agrees to pay the tuition required to attend College C in 10 equal monthly installments to Company B. Under the written agreement, Student A is not relieved of her obligation to pay College C until Company B remits the payments to College C. Under the written agreement, Company B agrees to disburse the monthly installment payments to College C within 30 days of receipt. Because Company B acts as Student A's agent for purposes of paying qualified expenses to College C, Student A is treated as paying qualified expenses on the date Company B disburses payments to College C.

(f) *Refund of qualified tuition and related expenses—(1) Payment and refund of qualified tuition and related expenses in the same taxable year*. With respect to any student, the amount of qualified tuition and related expenses for a taxable year is calculated by adding all qualified tuition and related expenses paid for the taxable year, and subtracting any refund of such expenses received from the eligible educational institution during the same taxable year (including refunds of loan proceeds described in paragraph (f)(4) of this section).

(2) *Payment of qualified tuition and related expenses in one taxable year and refund in subsequent taxable year before return filed for prior taxable year*. If, in a taxable year, a taxpayer or someone other than the taxpayer receives a refund (including refunds of loan proceeds described in paragraph (f)(4) of this section) of qualified tuition and related expenses paid on behalf of a student in a prior taxable year and the refund is received before the taxpayer files a federal income tax return for the prior taxable year, the amount of the qualified tuition and related expenses for the prior taxable year is reduced by the amount of the refund.

(3) *Payment of qualified tuition and related expenses in one taxable year and refund in subsequent taxable year*—(i) *In general*. If, in a taxable year (refund year), a taxpayer or someone other than the taxpayer receives a refund (including refunds of loan proceeds described in paragraph (f)(4) of this section) of qualified tuition and related expenses paid on behalf of a student for which the taxpayer claimed an education tax credit in a prior taxable year, the tax imposed by chapter 1 of the Internal Revenue Code for the refund year is increased by the recapture amount.

(ii) *Recapture amount*. The recapture amount is the difference in tax liability for the prior taxable year (taking into account any redetermination of such tax liability by audit or amended return) that results when the tax liability for the prior year is calculated using the taxpayer's redetermined credit. The redetermined credit is computed by reducing the amount of the qualified tuition and related expenses taken into account in determining any credit claimed in the prior taxable year by the amount of the refund of the qualified tuition and related expenses (redetermined qualified expenses), and computing the allowable credit using the redetermined qualified expenses and the relevant facts and circumstances of the prior taxable year, such as modified adjusted gross income (redetermined credit).

(4) *Refund of loan proceeds treated as refund of qualified tuition and related expenses*. If loan proceeds used to pay qualified tuition and related expenses (as described in paragraph (e)(3) of this section) during a taxable year are refunded by an eligible educational institution to a lender on behalf of the borrower, the refund is treated as a refund of qualified tuition and related expenses for purposes of paragraphs (f)(1), (2), and (3) of this section.

(5) *Excludable educational assistance received in a subsequent taxable year treated as a refund*. If, in a taxable year, a taxpayer or someone other than the taxpayer receives any excludable educational assistance (described in paragraph (c)(1) of this section) for the qualified tuition and related expenses paid on behalf of a student during a prior taxable year (or attributable to enrollment at an eligible educational institution during a prior taxable year), the educational assistance is treated as a refund of qualified tuition and related expenses for purposes of paragraphs (f)(2) and (3) of this section. If the excludable educational assistance is received before the taxpayer files a federal income tax return for the prior taxable year, the amount of the qualified tuition and related expenses for the prior taxable year is reduced by the amount of the excludable educational assistance as provided in paragraph (f)(2) of this section. If the excludable educational assistance is received after the taxpayer has filed a federal income tax return for the prior taxable year, any education tax credit claimed for the prior taxable year is

subject to recapture as provided in paragraph (f)(3) of this section.

(6) *Examples.* The following examples illustrate the rules of this paragraph (f). In each example, assume that all the requirements to claim an education tax credit are met. The examples are as follows:

Example 1. In January 1998, Student A, a full-time freshman at University X, pays $2,000 for qualified tuition and related expenses for a 16-hour work load for the 1998 Spring semester. Prior to beginning classes, Student A withdraws from 6 course hours. On February 15, 1998, Student A receives a $750 refund from University X. In September 1998, Student A pays University X $1,000 to enroll half-time for the 1998 Fall semester. Prior to beginning classes, Student A withdraws from a 2-hour course, and she receives a $250 refund in October 1998. Student A computes the amount of qualified tuition and related expenses she may claim for 1998 by:

(i) Adding all qualified expenses paid during the taxable year ($2,000 + 1,000 = $3,000);

(ii) Adding all refunds of qualified tuition and related expenses received during the taxable year ($750 + $250 = $1,000); and, then

(iii) Subtracting paragraph (ii) of this *Example 1* from paragraph (i) of this *Example 1* ($3,000 −$1,000 = $2,000). Therefore, Student A's qualified tuition and related expenses for 1998 are $2,000.

Example 2. (i) In December 1998, Student B, a senior at College Y, pays $2,000 for qualified tuition and related expenses for a 16-hour work load for the 1999 Spring semester. Prior to beginning classes, Student B withdraws from a 4-hour course. On January 15, 1999, Student B files her 1998 income tax return and claims a $400 Lifetime Learning Credit for the $2,000 qualified expenses paid in 1998, which reduces her tax liability for 1998 by $400. On February 15, 1999, Student B receives a $500 refund from College Y.

(ii) Student B calculates the increase in tax for 1999 by—

(A) Calculating the redetermined qualified expenses for 1998 ($2,000 − $500 = $1,500);

(B) Calculating the redetermined credit for the redetermined qualified expenses ($1,500 × .20 = $300); and

(C) Calculating the difference in tax liability for 1998 resulting from the redetermined credit. Because Student B's tax liability for 1998 was reduced by the full amount of the $400 education tax credit claimed on her 1998 income tax return, the difference in tax liability can be determined by subtracting the redetermined credit from the credit claimed in 1998 ($400−$300 = $100).

(iii) Therefore, Student B must increase the tax on her 1999 federal income tax return by $100.

Example 3. In September 1998, Student C pays College Z $1,200 in qualified tuition and related expenses to attend evening classes during the 1998 Fall semester. Student C is an employee of Company R. On January 15, 1999, Student C files a federal income tax return for 1998 claiming a Lifetime Learning Credit of $240 (.20 × $1,200), which reduces Student C's tax liability for 1998 by $240. Pursuant to an educational assistance program described in section 127(b), Company R reimburses Student C in February 1999 for the $1,200 of qualified tuition and related expenses paid by Student C in 1998. The $240 education tax credit claimed by Student C for 1998 is subject to recapture. Because Student C paid no net qualified tuition and related expenses for 1998, the redetermined credit for 1998 is zero. Student C must increase the amount of Student C's 1999 tax by the recapture amount, which is $240 (the difference in tax liability for 1998 resulting from the redetermined credit for 1998 ($0)). Because the $1,200 reimbursement relates to expenses for which the taxpayer claimed an education tax credit in a prior year, the reimbursement does not reduce the amount of any qualified tuition and related expenses that Student C paid in 1999.

[T.D. 9034, 67 FR 78691, Dec. 26, 2002; 68 FR 15940, Apr. 2, 2003]

§ 1.28–0 Credit for clinical testing expenses for certain drugs for rare diseases or conditions; table of contents.

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[T.D. 8232, 53 FR 38710, Oct. 3, 1988; 53 FR 40879, Oct. 19, 1988]

§ 1.28–1 Credit for clinical testing expenses for certain drugs for rare diseases or conditions.

(a) *General rule.* Section 28 provides a credit against the tax imposed by chapter 1 of the Internal Revenue Code. The amount of the credit is equal to 50 percent of the qualified clinical testing expenses (as defined in paragraph (b) of this section) for the taxable year. The credit applies to qualified clinical testing expenses paid or incurred by the taxpayer after December 31, 1982, and before January 1, 1991. The credit may not exceed the taxpayer's tax liability for the taxable year (as determined under paragraph (d)(2) of this section).

(b) *Qualified clinical testing expenses*—(1) *In general.* Except as otherwise provided in paragraph (b)(3) of this section, the term ''qualified clinical testing expenses'' means the amounts which are paid or incurred during the taxable year which would constitute ''qualified research expenses'' within the meaning of section 41(b) (relating to the credit for increasing research activities) as modified by section 28(b)(1)(B) and paragraph (b)(2) of this section. For example, amounts paid or incurred for the acquisition of depreciable property used in the conduct of clinical testing (as defined in paragraph (c) of this section) are not qualified clinical testing expenses.

(2) *Modification of section 41(b).* For purposes of paragraph (b)(1) of this section, section 41(b) is modified by substituting ''clinical testing'' for ''qualified research'' each place it appears in paragraph (2) of section 41(b) (relating to in-house research expenses) and paragraph (3) of section 41(b) (relating to contract research expenses). In addition, ''100 percent'' is substituted for ''65 percent'' in paragraph (3)(A) of section 41(b).

(3) *Exclusion for amounts funded by another person*—(i) *In general.* The term ''qualified clinical testing expenses'' shall not include any amount which would otherwise constitute qualified clinical testing expenses, to the extent

such amount is funded by a grant, contract, or otherwise by another person (or any governmental entity). The determination of the extent to which an amount is funded shall be made in light of all the facts and circumstances. For a special rule regarding funding between commonly controlled businesses, see paragraph (d)(5)(iv) of § 1.28–1.

(ii) *Clinical testing in which taxpayer retains no rights.* If a taxpayer conducting clinical testing with respect to the designated drug for another person retains no substantial rights in the clinical testing under the agreement providing for the clinical testing the taxpayer's clinical testing expenses are treated as fully funded for purposes of section 28(b)(1)(C). Thus, for example, if the taxpayer incurs clinical testing expenses under an agreement that confers on another person the exclusive right to exploit the results of the clinical testing, those expenses do not constitute qualified clinical testing expenses because they are fully funded under this paragraph (b)(3)(ii). Incidental benefits to the taxpayer from the conduct of the clinical testing (for example, increased experience in the field of human clinical testing) do not constitute substantial rights in the clinical testing.

(iii) *Clinical testing in which taxpayer retains substantial rights*—(A) *In general.* If a taxpayer conducting clinical testing with respect to the designated drug for another person retains substantial rights in the clinical testing under the agreement providing for the clinical testing, the clinical testing expenses are funded to the extent of the payments (and fair market value of any property at the time of transfer) to which the taxpayer becomes entitled by conducting the clinical testing. The taxpayer shall reduce the amount paid or incurred by the taxpayer for the clinical testing expenses that would, but for section 28(b)(1)(C) constitute qualified clinical testing expenses of the taxpayer by the amount of the funding determined under the preceding sentence. Rights retained in the clinical testing are not treated as property for purposes of this paragraph (b)(3)(iii)(A). If the property that is transferred to the taxpayer is to be consumed in the clinical testing (for example, supplies), the taxpayer should exclude the value of that property from both the payments received and the expenses paid or incurred for the clinical testing.

(B) *Drug by drug determination.* The provisions of this paragraph (b)(3) shall be applied separately to each designated drug tested by the taxpayer.

(iv) *Funding for qualified clinical testing expenses determinable only in subsequent taxable years.* If, at the time the taxpayer files its return for a taxable year, it is impossible to determine to what extent some or all of the qualified clinical testing expenses may be funded, the taxpayer shall treat the clinical testing expenses as fully funded for purposes of that return. When the amount of funding for qualified clinical testing expenses is finally determined, the taxpayer should amend the return and any interim returns to reflect the amount of funding for qualified clinical testing expenses.

(4) *Special rule governing the application of section 41(b) beyond its expiration date.* For purposes of section 28 and this section, section 41(b), as amended, and the regulations thereunder shall be deemed to remain in effect after December 31, 1988.

(c) *Clinical testing*—(1) *In general.* The term ''clinical testing'' means any human clinical testing which—

(i) Is carried out under an exemption under section 505(i) of the Federal Food, Drug, and Cosmetic Act (21 U.S.C. 355(i)) and the regulations relating thereto (21 CFR part 312) for the purpose of testing a drug for a rare disease or condition as defined in paragraph (d)(1) of this section,

(ii) Occurs after the date the drug is designated as a drug for a rare disease or condition under section 526 of the Federal Food, Drug, and Cosmetic Act (21 U.S.C. 360bb),

(iii) Occurs before the date on which an application for the designated drug is approved under section 505(b) of the Federal Food, Drug, and Cosmetic Act (21 U.S.C. 355(b)) or, if the drug is a biological product (other than a radioactive biological product intended for human use), before the date on which a license for such drug is issued under section 351 of the Public Health Services Act (42 U.S.C. 262), and

(iv) Is conducted by or on behalf of the taxpayer to whom the designation under section 526 of the Federal Food, Drug, and Cosmetic Act applies.

Human clinical testing shall be taken into account under this paragraph (c)(1) only to the extent that the testing relates to the use of a drug for the rare disease or condition for which the drug was designated under section 526 of the Federal Food, Drug, and Cosmetic Act. For purposes of paragraph (c)(1)(i) of this section the testing under section 505(i) exemption procedures (21 CFR part 312) of a biological product (other than a radioactive biological product intended for human use) pursuant to 21 CFR §601.21 is deemed to be carried out under an exemption under section 505(i) of the Federal Food, Drug, and Cosmetic Act.

(2) *Definition of "human clinical testing."* Testing is considered to be human clinical testing only to the extent that it uses human subjects to determine the effect of the designated drug on humans and is necessary for the designated drug either to be approved under section 505(b) of the Federal Food, Drug, and Cosmetic Act and the regulations thereunder (21 CFR part 314), or if the designated drug is a biological product (other than a radioactive biological product intended for human use), to be licensed under section 351 of the Public Health Services Act and the regulations thereunder (21 CFR part 601). For purposes of this paragraph (c)(2), a human subject is an individual who is a participant in research, either as a recipient of the drug or as a control. A subject may be either a healthy individual or a patient.

(3) *Definition of "carried out under" section 505(i).* Human clinical testing is not carried out under section 505(i) of the Federal Food, Drug, and Cosmetic Act and the regulations thereunder (21 CFR part 312) unless the primary purpose of the human clinical testing is to ascertain the data necessary to qualify the designated drug for sale in the United States, and not to ascertain data unrelated or only incidentally related to that needed to qualify the designated drug. Whether or not this primary purpose test is met shall be determined in light of all of the facts and circumstances.

(d) *Definition and special rules*—(1) *Definition of "rare disease or condition"*—(i) *In general.* The term "rare disease or condition" means any disease or condition which—

(A) Afflicts 200,000 or fewer persons in the United States, or

(B) Afflicts more than 200,000 persons in the United States but for which there is no reasonable expectation that the cost of developing and making available in the United States (as defined in section 7701(a)(9)) a drug for such disease or condition will be recovered from sales in the United States (as so defined) of such drug.

Determinations under paragraph (d)(1)(i)(B) of this section with respect to any drug shall be made on the basis of the facts and circumstances as of the date such drug is designated under section 526 of the Federal Food, Drug, and Cosmetic Act. Examples of diseases or conditions which in 1987 afflicted 200,000 or fewer persons in the United States are Duchenne dystrophy, one of the muscular dystrophies; Huntington's disease, a hereditary chorea; myoclonus; Tourette's syndrome; and amyotrophic lateral sclerosis (ALS or Lou Gehrig's disease).

(ii) *Cost of developing and making available the designated drug*—(A) *In general.* Except as otherwise provided in this paragraph (d)(1)(ii), the taxpayer's computation of the cost of developing and making available in the United States the designated drug shall include only the costs that the taxpayer (or any person whose right to make sales of the drug is directly or indirectly derived from the taxpayer, e.g., a licensee or transferee) has incurred or reasonably expects to incur in developing and making available in the United States the designated drug for the disease or condition for which it is designated. For example, if, prior to designation under section 526, the taxpayer incurred costs of $125,000 to test the drug for the rare disease or condition for which it is subsequently designated and incurred $500,000 to test the same drug for other diseases, and if, on the date of designation, the taxpayer expects to incur costs of $1.2 million to test the drug for the rare disease or condition for which it is designated, the taxpayer shall include in its cost computation both the $125,000 incurred prior to designation and the $1.2 million expected to be incurred after designation to test the drug for the rare disease or condition for which it is designated. The taxpayer shall not include the $500,000 incurred to test the drug for other diseases.

(B) *Exclusion of costs funded by another person.* In computing the cost of developing and making available in the United States the designated drug, the taxpayer shall not include any cost incurred or expected to be incurred by the taxpayer to the extent that the cost is funded or is reasonably expected to be funded (determined under the principles of paragraph (b)(3)) by a grant, contract, or otherwise by another person (or any governmental entity).

(C) *Computation of cost.* The cost computation shall use only reasonable costs incurred after the first indication of an orphan application for the designated drug. Such costs shall include the costs of obtaining data needed, and of meetings to be held, in connection with a request for FDA assistance under section 525 of the Federal, Food, Drug, and Cosmetic Act (21 U.S.C. 360aa) or a request for orphan designation under section 526 of that Act; costs of determining patentability of the drug; costs of screening, animal and clinical studies; costs associated with preparation of a Notice of Claimed Investigational Exemption for a New Drug (IND) and a New Drug Application (NDA); costs of possible distribution of drug under a ''treatment'' protocol; costs of development of a dosage form; manufacturing costs; distribution costs; promotion costs; costs to maintain required records and reports; and costs of the taxpayer in acquiring the right to market a drug from the owner of that right prior to designation. The taxpayer shall also include general overhead, depreciation costs and premiums for insurance against liability losses to the extent that the taxpayer can demonstrate that these costs are properly allocable to the designated drug under the established standards of financial accounting and reporting of research and development costs.

(D) *Allocation of common costs. Costs for developing and making available the designated drug for both the disease or condition for which it is designated and one or more other diseases or conditions.* In the case where the costs incurred or expected to be incurred in developing and making available the designated drug for the disease or condition for which it is designated are also incurred or expected to be incurred in developing and making available in the United States the same drug for one or more other diseases or conditions (whether or not they are also designated or expected to be designated), the costs shall be allocated between the cost of developing and making available the designated drug for the disease or condition for which the drug is designated and the cost of developing and making available the designated drug for the other diseases or conditions. The amount of the common costs to be allocated to the cost of developing and making available the designated drug for the disease or condition for which it is designated is determined by multiplying the common costs by a fraction the numerator of which is the sum of the expected amount of sales in the United States of the designated drug for the disease or condition for which the drug is designated and the denominator of which is the total expected amount of sales in the United States of the designated drug. For example, if prior to designation, the taxpayer incurs (among other costs) costs of $100,000 in testing the designated drug for its toxic effect on animals (without reference to any disease or condition), and if the taxpayer expects to recover $500,000 from sales in the United States of the designated drug for disease X, the disease for which the drug is designated, and further expects to recover another $1.5 million from the sales in the United States of the designated drug for disease Y, the taxpayer must allocate a proportionate amount of the common costs of $100,000 to the cost of developing and making available the designated drug for both disease X and disease Y. Since the ratio of the expected amount of sales in the United States of the designated drug for disease X to the total of both the expected amount of sales in the United States of the designated drug for disease X and the expected amount of sales in the United States of the designated drug for disease Y is $500,000/$2,000,000, 25% of the common costs of $100,000 (*i.e.*, $25,000) is allocated to the cost of developing and making available the designated drug for disease X.

(iii) *Recovery from sales.* In determining whether the taxpayer's cost described in paragraph (d)(1)(ii) of this section will be recovered from sales in the United States of the designated drug for the disease or condition for which the drug is designated, the taxpayer shall include anticipated sales by the taxpayer or any person whose right to make such sales is directly or indirectly derived from the taxpayer (such as a licensee or transferee). The anticipated sales shall be based upon the size of the anticipated patient population for which the designated drug would be useful, including the following factors: the degree of effectiveness and safety of the designated drug, if known: the projected fraction of the anticipated patient population expected to be given the designated drug and to continue to take it; other available agents and other types of therapy; the likelihood that superior agents will become available within a few years; and the number of years during which the designated drug would be exclusively available, e.g., under a patent.

(iv) *Recordkeeping requirements.* The taxpayer shall keep records sufficient to substantiate the cost and sales estimates made pursuant to this paragraph (d)(1). The records required by this paragraph (d)(1)(iv) shall be retained so long as the contents thereof may become material in the administration of section 28.

(2) *Tax liability limitation*—(i) *Taxable years beginning after December 31, 1986.* The credit allowed by section 28 shall not exceed the excess (if any) of—

(A) The taxpayer's regular tax liability for the taxable year (as defined in section 26(b)), reduced by the sum of the credits allowable under—

(*1*) Section 21 (relating to expenses for household and dependent care services necessary for gainful employment),

(*2*) Section 22 (relating to the elderly and permanently and totally disabled),

(*3*) Section 23 (relating to residential energy),

(*4*) Section 25 (relating to interest on certain home mortgages), and

(*5*) Section 27 (relating to taxes on foreign countries and possessions of the United States), over

(B) The tentative minimum tax for the taxable year (as determined under section 55(b)(1)).

(ii) *Taxable years beginning before January 1, 1987, and after December 31, 1983.* The credit allowed by section 28 shall not exceed the taxpayer's tax liability for the taxable year (as defined in section 26 (b) prior to its amendment by the Tax Reform Act of 1986 (Pub. L. 99–514)), reduced by the sum of the credits allowable under—

(A) Section 21 (relating to expenses for household dependent care services necessary for gainful employment),

(B) Section 22 (relating to the elderly and permanently and totally disabled),

(C) Section 23 (relating to residential energy),

(D) Section 24 (relating to contributions to candidates for public office),

(E) Section 25 (relating to interest on certain home mortgages), and

(F) Section 27 (relating to the taxes on foreign countries and possessions of the United States).

(iii) *Taxable years beginning before January 1, 1984.* The credit allowed by section 28 shall not exceed the amount of the tax imposed by chapter 1 of the Internal Revenue Code for the taxable year, reduced by the sum of the credits allowable under the following sections as designated prior to the enactment of the Tax Reform Act of 1984 (Pub. Law 98–369):

(A) Section 32 (relating to tax withheld at source on nonresident aliens and foreign corporations and on tax-free convenant bonds),

(B) Sections 33 (relating to taxes of foreign countries and possessions of the United States),

(C) Section 37 (relating to the retirement income),

(D) Section 38 (relating to investment in certain depreciable property),

(E) Section 40 (relating to expenses of work incentive programs).

(F) Section 41 (relating to contributions to candidates for public office).

(G) Section 44 (relating to purchase of new principal residence).

(H) Section 44A (relating to expenses for household and dependent care services necessary for gainful employment).

(I) Section 44B (relating to employment of certain new employees).

(J) Section 44C (relating to residential energy).

(K) Section 44D (relating to producing fuel from a nonconventional source).

(L) Section 44E (relating to alcohol used as fuel).

(M) Section 44F (relating to increasing research activities), and

(N) Section 44G (relating to employee stock ownership).

The term ''tax imposed by chapter 1'' as used in this paragraph (d)(2)(iii) does not include any tax treated as not imposed by chapter 1 of the Internal Revenue Code under the last sentence of section 53(a).

(3) *Special limitations on foreign testing*—(i) *Clinical testing conducted outside of the United States—In general.* Except as otherwise provided in this paragraph (d)(3), expenses paid or incurred with respect to clinical testing conducted outside the United States (as defined in section 7701(a)(9)) are not eligible for credit under this section. Thus, for example, wages paid an employee clinical investigator for clinical testing conducted in medical facilities in the United States and Mexico generally must be apportioned between the clinical testing conducted within the United States and the clinical testing conducted outside the United States, and only the wages apportioned to the clinical testing conducted within the United States are qualified clinical testing expenses.

(ii) *Insufficient testing population in the United States*—(A) *In general.* If clinical testing is conducted outside of the United States because there is an insufficient testing population in the United States, and if the clinical testing is conducted by a United States person (as defined in section 7701(a)(30)) or is conducted by any other person unrelated to the taxpayer to whom the designation under section 526 of the Federal Food, Drug, and Cosmetic Act applies, then the expenses paid or incurred for clinical testing conducted outside of the United States are eligible for the credit provided by section 28.

(B) ''*Insufficient testing population.*'' The testing population in the United States is insufficient if there are not within the United States the number of available and appropriate human subjects needed to produce reliable data from the clinical investigation.

(C) ''*Unrelated to the taxpayer.*'' For the purpose of determining whether a person is unrelated to the taxpayer to whom the designation under section 526 of the Federal Food, Drug, and Cosmetic Act and the regulations thereunder applies, the rules of section 613A(d)(3) shall apply except that the number ''5'' in section 613A(d)(3) (A), (B), and (C) shall be deleted and the number ''10'' inserted in lieu thereof.

(4) *Special limitations for certain corporations*—(i) *Corporations to which section 936 applies.* Expenses paid or incurred for clinical testing conducted either inside or outside the United States by a corporation to which section 936 (relating to Puerto Rico and possessions tax credit) applies are not eligible for the credit under section 28.

(ii) *Corporations to which section 934(b) applies.* For taxable years beginning before January 1, 1987, expenses paid or incurred for clinical testing conducted either inside or outside the United States by a corporation to which section 934(b) (relating to the limitation on reduction in income tax liability incurred to the Virgin Islands), as in effect prior to its amendment by the Tax Reform Act of 1986, applies are not eligible for the credit under section 28. For taxable years beginning after December 31, 1986, see section 1277(c)(1) of the Tax Reform Act of 1986 (100 Stat. 2600) which makes the rule set forth in the preceding sentence inapplicable with respect to corporations created or organized in the Virgin Islands only if (and so long as) an implementing agreement described in that section is in effect between the United States and the Virgin Islands.

(5) *Aggregation of expenditures*—(i) *Controlled group of corporations; organizations under common control*—(A) *In*

general. In determining the amount of the credit allowable with respect to an organization that at the end of its taxable year is a member of a controlled group of corporations or a member of a group of organizations under common control, all members of the group are treated as a single taxpayer and the credit (if any) allowable to the member is determined on the basis of its proportionate share of the qualified clinical testing expenses of the aggregated group.

(B) *Definition of controlled group of corporations*. For purposes of this section, the term ''controlled group of corporations'' shall have the meaning given to the term by section 41(f)(5).

(C) *Definition of organization*. For purposes of this section, an organization is a sole proprietorship, a partnership, a trust, an estate, or a corporation, that is carrying on a trade or business (within the meaning of section 162). For purposes of this section, any corporation that is a member of a commonly controlled group shall be deemed to be carrying on a trade or business if any other member of that group is carrying on any trade or business.

(D) *Determination of common control*. Whether organizations are under common control shall be determined under the principles set forth in paragraphs (b) through (g) of 26 CFR 1.52–1.

(ii) *Tax accounting periods used*—(A) *In general*. The credit allowable to a member of a controlled group of corporations or a group of organizations under common control is that member's share of the aggregate credit computed as of the end of such member's taxable year.

(B) *Special rule where the timing of clinical testing is manipulated*. If the timing of clinical testing by members using different tax accounting periods is manipulated to generate a credit in excess of the amount that would be allowable if all members of the group used the same tax accounting period, the district director may require all members of the group to calculate the credit in the current taxable year and all future years by using the ''conformed years'' method. Each member computing a credit under the ''conformed years'' method shall compute the credit as if all members of the group had the same taxable year as the computing member.

(iii) *Membership during taxable year in more than one group*. An organization may be a member of only one group for a taxable year. If, without application of this paragraph (d)(5)(iii), an organization would be a member of more than one group at the end of its taxable year, the organization shall be treated as a member of the group in which it was included for its preceding taxable year. If the organization was not included for its preceding taxable year in any group in which it could be included as of the end of its taxable year, the organization shall designate in its timely filed return the group in which it is being included. If the return for a taxable year is due before May 1, 1985, the organization may designate its group membership through an amended return for that year filed on or before April 30, 1985. If the organization does not so designate, then the district director with audit jurisdiction of the return will determine the group in which the business is to be included.

(iv) *Intra-group transactions*—(A) *In general*. Because all members of a group under common control are treated as a single taxpayer for purposes of determining the credit, transactions between members of the group are generally disregarded.

(B) *In-house research expenses*. If one member of a group conducts clinical testing on behalf of another member, the member conducting the clinical testing shall include in its qualified clinical testing expenses any in-house research expenses for that work and shall not treat any amount received or accrued from the other member as funding the clinical testing. Conversely, the member for whom the clinical testing is conducted shall not treat any part of any amount paid or incurred as a contract research expense. For purposes of determining whether the in-house research for that work is clinical testing, the member performing the clinical testing shall be treated as carrying on any trade or business carried on by the member on whose behalf the clinical testing is performed.

(C) *Contract research expenses.* If a member of a group pays or incurs contract research expenses to a person outside the group in carrying on the member's trade or business, that member shall include those expenses as qualified clinical testing expenses. However, if the expenses are not paid or incurred in carrying on any trade or business of that member, those expenses may be taken into account as contract research expenses by another member of the group provided that the other member—

(*1*) Reimburses the member paying or incurring the expenses, and

(*2*) Carries on a trade or business to which the clinical testing relates.

(D) *Lease payments.* Amounts paid or incurred to another member of the group for the lease of personal property owned by a person outside the group shall be taken into account as in-house research expenses for purposes of section 28 only to the extent of the lesser of—

(*1*) The amount paid or incurred to the other member, or

(*2*) The amount of the lease expense paid to a person outside the group.

The amount paid or incurred to another member of the group for the lease of personal property owned by a member of the group is not taken into account for purposes of section 28.

(E) *Payment for supplies.* Amounts paid or incurred to another member of the group for supplies shall be taken into account as in-house research expenses for purposes of section 28 only to the extent of the lesser of—

(*1*) The amount paid or incurred to the other member, or

(*2*) The amount of the other member's basis in the supplies.

(6) *Allocations*—(i) *Pass-through in the case of an S corporation.* In the case of an S corporation (as defined in section 1361), the amount of the credit for qualified clinical testing expenses computed for the corporation for any taxable year shall be allocated among the persons who are shareholders of the corporation during the taxable year according to the provisions of section 1366 and section 1377.

(ii) *Pass-through in the case of an estate or a trust.* In the case of an estate or a trust, the amount of the credit for qualified clinical testing expenses computed for the estate or trust for any taxable year shall be apportioned between the estate or trust and the beneficiaries on the basis of the income of the estate or trust allocable to each.

(iii) *Pass-through in the case of a partnership*—(A) *In general.* In the case of a partnership, the credit for qualified clinical testing expenses computed for the partnership for any taxable year shall be apportioned among the persons who are partners during the taxable year in accordance with section 704 and the regulations thereunder.

(B) *Certain partnership non-business expenditures.* A partner's share of an in-house research expense or contract research expense paid or incurred by a partnership other than in carrying on a trade or business of the partnership constitutes a qualified clinical testing expense of the partner if—

(*1*) The partner is entitled to make independent use of the result of the clinical testing, and

(*2*) The clinical testing expense paid or incurred in carrying on the clinical testing would have been paid or incurred by the partner in carrying on a trade or business of the partner if the partner had carried on the clinical testing that was in fact carried on by the partnership.

(C) *Apportionment.* Qualified clinical testing expenses to which paragraph (d)(6)(iii)(B) of this section applies shall be apportioned among the persons who are partners during the taxable year in accordance with section 704 and the regulations thereunder. For purposes of section 28, these expenses shall be treated as paid or incurred directly by the partners rather than by the partnership. Thus, the partnership shall disregard these expenses in computing the credit to be apportioned under paragraph (d)(6)(iii)(A) of this section, and each partner shall aggregate the portion of these expenses allocated to the partner with other qualified clinical testing expenses of the partner in making the computations under section 28.

(iv) *Year in which taken into account.* An amount apportioned to a person under paragraph (d)(6) of this section shall be taken into account by the person in the taxable year of such person in which or with which the taxable year of the corporation, estate, trust, or partnership (as the case may be) ends.

(v) *Credit allowed subject to limitation.* Any person to whom any amount has been apportioned under paragraph (d)(6)(i), (ii), or (iii) of this section is allowed, subject to the limitation provided in section 28(d)(2), a credit for that amount.

(7) *Manner of making an election.* To make an election to have section 28 apply for its taxable year, the taxpayer shall file Form 6765 (Credit for Increasing Research Activities (or for claiming the orphan drugs credit)) containing all the information required by that form.

[T.D. 8232, 53 FR 38711, Oct. 3, 1988; 53 FR 40879, Oct. 19, 1988; 53 FR 41013, Oct. 19, 1988]

CREDITS AGAINST TAX

CREDITS ALLOWABLE UNDER SECTIONS 30 THROUGH 45D

§ 1.30–1 Definition of qualified electric vehicle and recapture of credit for qualified electric vehicle.

(a) *Definition of qualified electric vehicle.* A qualified electric vehicle is a motor vehicle that meets the requirements of section 30(c). Accordingly, a qualified electric vehicle does not include any motor vehicle that has ever been used (for either personal or business use) as a non-electric vehicle.

(b) *Recapture of credit for qualified electric vehicle*—(1) *In general*—(i) *Addition to tax.* If a recapture event occurs with respect to a taxpayer's qualified electric vehicle, the taxpayer must add the recapture amount to the amount of tax due in the taxable year in which the recapture event occurs. The recapture amount is not treated as income tax imposed on the taxpayer by chapter 1 of the Internal Revenue Code for purposes of computing the alternative minimum tax or determining the amount of any other allowable credits for the taxable year in which the recapture event occurs.

(ii) *Reduction of carryover.* If a recapture event occurs with respect to a taxpayer's qualified electric vehicle, and if a portion of the section 30 credit for the cost of that vehicle was disallowed under section 30(b)(3)(B) and consequently added to the taxpayer's minimum tax credit pursuant to section 53(d)(1)(B)(iii), the taxpayer must reduce its minimum tax credit carryover by an amount equal to the portion of any minimum tax credit carryover attributable to the disallowed section 30 credit, multiplied by the recapture percentage for the taxable year of recapture. Similarly, the taxpayer must reduce any other credit carryover amounts (such as under section 469) by the portion of the carryover attributable to section 30, multiplied by the recapture percentage.

(2) *Recapture event*—(i) *In general.* A recapture event occurs if, within 3 full years from the date a qualified electric vehicle is placed in service, the vehicle ceases to be a qualified electric vehicle. A vehicle ceases to be a qualified electric vehicle if—

(A) The vehicle is modified so that it is no longer primarily powered by electricity;

(B) The vehicle is used in a manner described in section 50(b); or

(C) The taxpayer receiving the credit under section 30 sells or disposes of the vehicle and knows or has reason to know that the vehicle will be used in a manner described in paragraph (b)(2)(i)(A) or (B) of this section.

(ii) *Exception for disposition.* Except as provided in paragraph (b)(2)(i)(C) of this section, a sale or other disposition (including a disposition by reason of an accident or other casualty) of a qualified electric vehicle is not a recapture event.

(3) *Recapture amount.* The recapture amount is equal to the recapture percentage times the decrease in the credits allowed under section 30 for all prior taxable years that would have resulted solely from reducing to zero the cost taken into account under section 30 with respect to such vehicle, including any credits allowed attributable to section 30 (such as under sections 53 and 469).

(4) *Recapture date.* The recapture date is the actual date of the recapture event unless a recapture event described in paragraph (b)(2)(i)(B) of this section occurs, in which case the recapture date is the first day of the recapture year.

(5) *Recapture percentage.* For purposes of this section, the recapture percentage is—

(i) 100, if the recapture date is within the first full year after the date the vehicle is placed in service;

(ii) 66⅔, if the recapture date is within the second full year after the date the vehicle is placed in service; or

(iii) 33⅓, if the recapture date is within the third full year after the date the vehicle is placed in service.

(6) *Basis adjustment.* As of the first day of the taxable year in which the recapture event occurs, the basis of the qualified electric vehicle is increased by the recapture amount and the carryover reductions taken into account under paragraphs (b)(1)(i) and (ii) of this section, respectively. For a vehicle that is of a character that is subject to an allowance for depreciation, this increase in basis is recoverable over the remaining recovery period for the vehicle beginning as of the first day of the taxable year of recapture.

(7) *Application of section 1245 for sales and other dispositions.* For purposes of section 1245, the amount of the credit allowable under section 30(a) with respect to any qualified electric vehicle that is (or has been) of a character subject to an allowance for depreciation is treated as a deduction allowed for depreciation under section 167. Therefore, upon a sale or other disposition of a depreciable qualified electric vehicle, section 1245 will apply to any gain recognized to the extent the basis of the depreciable vehicle was reduced under section 30(d)(1) net of any basis increase described in paragraph (b)(6) of this section.

(8) *Examples.* The following examples illustrate the provisions of this section:

Example 1. A, a calendar-year taxpayer, purchases and places in service for personal use on January 1, 1995, a qualified electric vehicle costing $25,000. On A's 1995 federal income tax return, A claims a credit of $2,500. On January 2, 1996, A sells the vehicle to an unrelated third party who subsequently converts the vehicle into a non-electric vehicle on October 15, 1996. There is no recapture upon the sale of the vehicle by A provided A did not know or have reason to know that the purchaser intended to convert the vehicle to non-electric use.

Example 2. B, a calendar-year taxpayer, purchases and places in service for personal use on October 11, 1994, a qualified electric vehicle costing $20,000. On B's 1994 federal income tax return, B claims a credit of $2,000, which reduces B's tax by $2,000. The basis of the vehicle is reduced to $18,000 ($20,000 − $2,000). On March 8, 1996, B sells the vehicle to a tax-exempt entity. Because B knowingly sold the vehicle to a tax-exempt entity described in section 50(b) in the second full year from the date the vehicle was placed in service, B must recapture $1,333 ($2,000 × 66⅔ percent). This recapture amount increases B's tax by $1,333 on B's 1996 federal income tax return and is added to the basis of the vehicle as of January 1, 1996, the beginning of the taxable year in which the recapture event occurred.

Example 3. X, a calendar-year taxpayer, purchases and places in service for business use on January 1, 1994, a qualified electric vehicle costing $30,000. On X's 1994 federal income tax return, X claims a credit of $3,000, which reduces X's tax by $3,000. The basis of the vehicle is reduced to $27,000 ($30,000 − $3,000) prior to any adjustments for depreciation. On March 8, 1995, X converts the qualified electric vehicle into a gasoline-propelled vehicle. Because X modified the vehicle so that it is no longer primarily powered by electricity in the second full year from the date the vehicle was placed in service, X must recapture $2,000 ($3,000 × 66⅔ percent). This recapture amount increases X's tax by $2,000 on X's 1995 federal income tax return. The recapture amount of $2,000 is added to the basis of the vehicle as of January 1, 1995, the beginning of the taxable year of recapture, and to the extent the property remains depreciable, the adjusted basis is recoverable over the remaining recovery period.

Example 4. The facts are the same as in *Example 3.* In 1996, X sells the vehicle for $31,000, recognizing a gain from this sale. Under paragraph (b)(7) of this section, section 1245 will apply to any gain recognized on the sale of a depreciable vehicle to the extent the basis of the vehicle was reduced by the section 30 credit net of any basis increase from recapture of the section 30 credit. Accordingly, the gain from the sale of the vehicle is subject to section 1245 to the extent of the depreciation allowance for the vehicle plus the credit allowed under section 30 ($3,000), less the previous recapture amount ($2,000). Any remaining amount of gain may be subject to other applicable provisions of the Internal Revenue Code.

(c) *Effective date.* This section is effective on October 14, 1994. If the recapture date is before the effective date of this section, a taxpayer may use any reasonable method to recapture the benefit of any credit allowable under section 30(a) consistent with section 30 and its legislative history. For this purpose, the recapture date is defined in paragraph (b)(4) of this section.

[60 FR 39649, Aug. 3, 1995]

§ 1.31–1 Credit for tax withheld on wages.

(a) The tax deducted and withheld at the source upon wages under chapter 24 of the Internal Revenue Code of 1954 (or in the case of amounts withheld in 1954, under subchapter D, chapter 9 of the Internal Revenue Code of 1939) is allowable as a credit against the tax imposed by Subtitle A of the Internal Revenue Code of 1954, upon the recipient of the income. If the tax has actually been withheld at the source, credit or refund shall be made to the recipient of the income even though such tax has not been paid over to the Government by the employer. For the purpose of the credit, the recipient of the income is the person subject to tax imposed under Subtitle A upon the wages from which the tax was withheld. For instance, if a husband and wife domiciled in a State recognized as a community property State for Federal tax purposes make separate returns, each reporting for income tax purposes one- half of the wages received by the husband, each spouse is entitled to one-half of the credit allowable for the tax withheld at source with respect to such wages.

(b) The tax withheld during any calendar year shall be allowed as a credit against the tax imposed by Subtitle A for the taxable year of the recipient of the income which begins in that calendar year. If such recipient has more than one taxable year beginning in that calendar year, the credit shall be allowed against the tax for the last taxable year so beginning.

§ 1.31–2 Credit for "special refunds" of employee social security tax.

(a) *In general.* (1) In the case of an employee receiving wages from more than one employer during the calendar year, amounts may be deducted and withheld as employee social security tax with respect to more than $3,600 of wages received during the calendar year 1954, and with respect to more than $4,200 of wages received during a calendar year after 1954. For example, employee social security tax may be deducted and withheld on $5,000 of wages received by an employee during a particular calendar year if the employee is paid wages in such year in the amount of $3,000 by one employer and in the amount of $2,000 by another employer. Section 6413(c) (as amended by section 202 of the Social Security Amendments of 1954 (68 Stat. 1089)), permits, under certain conditions, a so-called ''special refund'' of the amount of employee social security tax deducted and withheld with respect to wages paid to an employee in a calendar year after 1954 in excess of $4,200 ($3,600 for the calendar year 1954) by reason of the employee receiving wages from more than one employer during the calendar year. For provisions relating to the imposition of the employee tax and the limitation on wages, see with respect to the calendar year 1954, sections 1400 and 1426(a)(1) of the Internal Revenue Code of 1939 and, with respect to calendar years after 1954, sections 3101 and 3121(a)(1) of the Internal Revenue Code of 1954, as amended by sections 208(b) and 204(a), respectively, of the Social Security Amendments of 1954 (68 Stat. 1094, 1091).

(2) An employee who is entitled to a special refund of employee tax with respect to wages received during a calendar year and who is also required to file an income tax return for such calendar year (or for his last taxable year beginning in such calendar year) may obtain the benefits of such special refund only by claiming credit for such special refund in the same manner as if such special refund were an amount deducted and withheld as income tax at the source. For provisions for claiming special refunds for 1955 and subsequent years in the case of employees not required to file income tax returns, see section 6413(c) and the regulations thereunder. For provisions relating to such refunds for 1954, see 26 CFR (1939) 408.802 (regulations 128).

(3) The amount of the special refund allowed as a credit shall be considered as an amount deducted and withheld as income tax at the source under chapter 24 of the Internal Revenue Code of 1954 (or, in the case of a special refund for

1954, subchapter D, chapter 9 of the Internal Revenue Code of 1939). If the amount of such special refund when added to amounts deducted and withheld as income tax exceeds the taxes imposed by subtitle A of the Internal Revenue Code of 1954, the amount of the excess constitutes an overpayment of income tax under Subtitle A, and interest on such overpayment is allowed to the extent provided under section 6611 upon an overpayment of income tax resulting from a credit for income tax withheld at source. See section 6401(b).

(b) *Federal and State employees and employees of certain foreign corporations.* The provisions of this section shall apply to the amount of a special refund allowable to an employee of a Federal agency or a wholly owned instrumentality of the United States, to the amount of a special refund allowable to an employee of any State or political subdivision thereof (or any instrumentality of any one or more of the foregoing), and to the amount of a special refund allowable to employees of certain foreign corporations. See, with respect to such special refunds for 1954, section 1401(d)(4) of the Internal Revenue Code of 1939, and with respect to such special refunds for 1955 and subsequent years, section 6413(c)(2) of the Internal Revenue Code of 1954, as amended by section 202 of the Social Security amendments of 1954.

§ 1.32–2 Earned income credit for taxable years beginning after December 31, 1978.

(a) [Reserved]

(b) *Limitations.* (1) [Reserved]

(2) *Married individuals.* No credit is allowed by section 32 in the case of an eligible individual who is married (within the meaning of section 7703 and the regulations thereunder) unless the individual and spouse file a single return jointly (a joint return) for the taxable year (see section 6013 and the regulations thereunder relating to joint returns of income tax by husband and wife). The requirements of the preceding sentence do not apply to an eligible individual who is not considered as married under section 7703(b) and the regulations thereunder (relating to certain married individuals living apart).

(3) *Length of taxable year.* No credit is allowed by section 32 in the case of a taxable year covering a period of less than 12 months. However, the rule of the preceding sentence does not apply to a taxable year closed by reason of the death of the eligible individual.

(c) *Definitions.* (1) [Reserved]

(2) *Earned income.* For purposes of this section, earned income is computed without regard to any community property laws which may otherwise be applicable. Earned income is reduced by any net loss in earnings from self-employment. Earned income does not include amounts received as a pension, an annuity, unemployment compensation, or workmen's compensation, or an amount to which section 871(a) and the regulations thereunder apply (relating to income of nonresident alien individuals not connected with United States business).

(d) [Reserved]

(e) *Coordination of credit with advance payments*—(1) *Recapture of excess advance payments.* If any advance payment of earned income credit under section 3507 is made to an individual by an employer during any calendar year, then the total amount of these advance payments to the individual in that calendar year is treated as an additional amount of tax imposed (by chapter 1 of the Code) upon the individual on the tax return for the individual's last taxable year beginning in that calendar year.

(2) *Reconciliation of payments advanced and credit allowed.* Any additional amount of tax under paragraph (e)(1) of this section is not treated as a tax imposed by chapter 1 of the Internal Revenue Code for purposes of determining the amount of any credit (other than the earned income credit) allowable under part IV, subchapter A, chapter 1 of the Internal Revenue Code.

[T.D. 7683, 45 FR 16175, Mar. 13, 1980. Redesignated by T.D. 8448, 57 FR 54923, Nov. 23, 1992; T.D. 9045, 68 FR 10656, Mar. 6, 2003]

§ 1.32–3 Eligibility requirements after denial of the earned income credit.

(a) *In general.* A taxpayer who has been denied the earned income credit (EIC), in whole or in part, as a result of the deficiency procedures under subchapter B of chapter 63 (deficiency procedures) is ineligible to file a return claiming the EIC subsequent to the denial until the taxpayer demonstrates eligibility for the EIC in accordance with paragraph (c) of this section. If a taxpayer demonstrates eligibility for a taxable year in accordance with paragraph (c) of this section, the taxpayer need not comply with those requirements for any subsequent taxable year unless the Service again denies the EIC as a result of the deficiency procedures.

(b) *Denial of the EIC as a result of the deficiency procedures.* For purposes of this section, denial of the EIC as a result of the deficiency procedures occurs when a tax on account of the EIC is assessed as a deficiency (other than as a mathematical or clerical error under section 6213(b)(1)).

(c) *Demonstration of eligibility.* In the case of a taxpayer to whom paragraph (a) of this section applies, and except as otherwise provided by the Commissioner in the instructions for Form 8862, ''Information To Claim Earned Income Credit After Disallowance,'' no claim for the EIC filed subsequent to the denial is allowed unless the taxpayer properly completes Form 8862, demonstrating eligibility for the EIC, and otherwise is eligible for the EIC. If any item of information on Form 8862 is incorrect or inconsistent with any item on the return, the taxpayer will be treated as not demonstrating eligibility for the EIC. The taxpayer must follow the instructions for Form 8862 to determine the income tax return to which Form 8862 must be attached. If the taxpayer attaches Form 8862 to an incorrect tax return, the taxpayer will not be relieved of the requirement that the taxpayer attach Form 8862 to the correct tax return and will, therefore, not be treated as meeting the taxpayer's obligation under paragraph (a) of this section.

(d) *Failure to demonstrate eligibility.* If a taxpayer to whom paragraph (a) of this section applies fails to satisfy the requirements of paragraph (c) of this section with respect to a particular taxable year, the IRS can deny the EIC as a mathematical or clerical error under section 6213(g)(2)(K).

(e) *Special rule where one spouse denied EIC.* The eligibility requirements set forth in this section apply to taxpayers filing a joint return where one spouse was denied the EIC for a taxable year prior to marriage and has not established eligibility as either an unmarried or married taxpayer for a subsequent taxable year.

(f) *Effective date.* This section applies to returns claiming the EIC for taxable years beginning after December 31, 1997, where the EIC was denied for a taxable year beginning after December 31, 1996.

[T.D. 8953, 66 FR 33637, June 25, 2001]

§ 1.34–1 Special rule for owners of certain business entities.

Amounts payable under sections 6420, 6421, and 6427 to a business entity that is treated as separate from its owner under § 1.1361–4(a)(8) (relating to certain qualified subchapter S subsidiaries) or § 301.7701–2(c)(2)(v) of this chapter (relating to certain wholly-owned entities) are, for purposes of section 34, treated as payable to the owner of that entity.

[T.D. 9356, 72 FR 45893, Aug. 16, 2007]

§ 1.35–1 Partially tax-exempt interest received by individuals.

(a) The credit against tax under section 35 shall be allowed only to individuals and if the requirements of both paragraphs (1) and (2) of section 35(a) are met. Where the alternative tax on capital gains is imposed under section 1201(b), the taxable income for such taxable year is the taxable income as defined in section 63, which includes 50 percent of the excess of net long-term capital gain over net short-term capital loss.

(b) For the treatment of partially tax-exempt interest in the case of amounts not allocable to any beneficiary of an estate or trust, see section 642(a)(1), and for treatment of amounts allocable to a beneficiary, see sections 652 and 662. For treatment of partially tax-exempt interest received by a partnership, see section 702(a)(7). For treatment of such interest received by a common trust fund, see section 584(c)(2).

(c) The application of section 35 may be illustrated by the following example:

Example. In his taxable year, 1955, A received $4,500 of partially tax-exempt interest. A's taxable income is $4,000 upon which the tax prior to any credits against tax is $840. His foreign tax credit under section 33 is $610, and his dividends received credit under section 34 is $120. A's credit under section 35 for partially tax-exempt interest is $110, determined as follows:

Section 35(a)		
Partially tax-exempt interest		$4,500
Credit computed under section 35(a); 3 percent of $4,500		135
Section 35(b)(1)		
Tax imposed by chapter 1		840
Less:		
Credit allowed under section 33	$610	
Credit allowed under section 34	120	
		$730
Limitation on credit under section 35(b)(1)		110
Section 35(b)(2)		
Taxable income		4,000
Limitation on credit under section 35(b)(2); 3 percent of $4,000		120

Since of the three figures ($135, $110, and $120), the lesser is $110, A's credit under section 35 is limited to $110.

§ 1.35–2 Taxpayers not entitled to credit.

For taxable years beginning after December 31, 1957, no credit shall be allowed under section 35 to a nonresident alien individual with respect to whom a tax is imposed for such taxable year under section 871(a).

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[T.D. 9590, 77 FR 30385, May 23, 2012, as amended by T.D. 9663, 79 FR 26117, May 7, 2014; T.D. 9745, 80 FR 78974, Dec. 18, 2015; T.D. 9604, 81 FR 91763, Dec. 19, 2016; T.D. 9822, 82 FR 34605, July 26, 2017]

§ 1.36B–1 Premium tax credit definitions.

(a) *In general.* Section 36B allows a refundable premium tax credit for taxable years ending after December 31, 2013. The definitions in this section apply to this section and §§ 1.36B–2 through 1.36B–5.

(b) *Affordable Care Act.* The term *Affordable Care Act* refers to the Patient Protection and Affordable Care Act, Public Law 111–148 (124 Stat. 119 (2010)), and the Health Care and Education Reconciliation Act of 2010, Public Law 111–152 (124 Stat. 1029 (2010)), as amended by the Medicare and Medicaid Extenders Act of 2010, Public Law 111–309 (124 Stat. 3285 (2010)), the Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011, Public Law 112–9 (125 Stat. 36 (2011)), the Department of Defense and Full-Year Continuing Appropriations Act, 2011, Public Law 112–10 (125 Stat. 38 (2011)), and the 3% Withholding Repeal and Job Creation Act, Public Law 112–56 (125 Stat. 711 (2011)).

(c) *Qualified health plan.* The term *qualified health plan* has the same meaning as in section 1301(a) of the Affordable Care Act (42 U.S.C. 18021(a)) but does not include a catastrophic plan described in section 1302(e) of the Affordable Care Act (42 U.S.C. 18022(e)).

(d) *Family and family size.* A taxpayer's family means the individuals for whom a taxpayer properly claims a deduction for a personal exemption under section 151 for the taxable year.

Family size means the number of individuals in the family. Family and family size may include individuals who are not subject to or are exempt from the penalty under section 5000A for failing to maintain minimum essential coverage.

(e) *Household income*—(1) *In general.* Household income means the sum of—

(i) A taxpayer's modified adjusted gross income (including the modified adjusted gross income of a child for whom an election under section 1(g)(7) is made for the taxable year);

(ii) The aggregate modified adjusted gross income of all other individuals who—

(A) Are included in the taxpayer's family under paragraph (d) of this section; and

(B) Are required to file a return of tax imposed by section 1 for the taxable year.

(2) *Modified adjusted gross income.* Modified adjusted gross income means adjusted gross income (within the meaning of section 62) increased by—

(i) Amounts excluded from gross income under section 911;

(ii) Tax-exempt interest the taxpayer receives or accrues during the taxable year; and

(iii) Social security benefits (within the meaning of section 86(d)) not included in gross income under section 86.

(f) *Dependent.* Dependent has the same meaning as in section 152.

(g) *Lawfully present.* Lawfully present has the same meaning as in 45 CFR 155.20.

(h) *Federal poverty line.* The Federal poverty line means the most recently published poverty guidelines (updated periodically in the FEDERAL REGISTER by the Secretary of Health and Human Services under the authority of 42 U.S.C. 9902(2)) as of the first day of the regular enrollment period for coverage by a qualified health plan offered through an Exchange for a calendar year. Thus, the Federal poverty line for computing the premium tax credit for a taxable year is the Federal poverty line in effect on the first day of the initial or annual open enrollment period preceding that taxable year. See 45 CFR 155.410. If a taxpayer's primary residence changes during a taxable year from one state to a state with different Federal poverty guidelines or married taxpayers reside in separate states with different Federal poverty guidelines (for example, Alaska or Hawaii and another state), the Federal poverty line that applies for purposes of section 36B and the associated regulations is the higher Federal poverty guideline (resulting in a lower percentage of the Federal poverty line for the taxpayers' household income and family size).

(i) [Reserved]

(j) *Advance credit payment.* Advance credit payment means an advance payment of the premium tax credit as provided in section 1412 of the Affordable Care Act (42 U.S.C. 18082).

(k) *Exchange.* Exchange has the same meaning as in 45 CFR 155.20.

(l) *Self-only coverage.* Self-only coverage means health insurance that covers one individual and provides coverage for the essential health benefits as defined in section 1302(b)(1) of the Affordable Care Act (42 U.S.C. 18022).

(m) *Family coverage.* Family coverage means health insurance that covers more than one individual and provides coverage for the essential health benefits as defined in section 1302(b)(1) of the Affordable Care Act (42 U.S.C. 18022).

(n) *Rating area.* The term *rating area* has the same meaning as used in section 2701(a)(2) of the Public Health Service Act (42 U.S.C. 300gg(a)(2)) and 45 CFR 147.102(b).

(o) *Effective/applicability date.* Except for paragraphs (l) and (m), this section applies to taxable years ending after December 31, 2013. Paragraphs (l) and (m) of this section apply to taxable years beginning after December 31, 2018. Paragraphs (l) and (m) of §1.36B–1 as contained in 26 CFR part I edition revised as of April 1, 2016, apply to taxable years ending after December 31, 2013, and beginning before January 1, 2019.

[T.D. 9590, 77 FR 30385, May 23, 2012, as amended by T.D. 9745, 80 FR 78974, Dec. 18, 2015; T.D. 9804, 81 FR 91763, Dec. 19, 2016]

§1.36B–2 Eligibility for premium tax credit.

(a) *In general.* An applicable taxpayer (within the meaning of paragraph (b) of this section) is allowed a premium assistance amount only for any month that one or more members of the applicable taxpayer's family (the applicable taxpayer or the applicable taxpayer's spouse or dependent)—

(1) Is enrolled in one or more qualified health plans through an Exchange; and

(2) Is not eligible for minimum essential coverage (within the meaning of paragraph (c) of this section) other than coverage described in section 5000A(f)(1)(C) (relating to coverage in the individual market).

(b) *Applicable taxpayer*—(1) *In general.* Except as otherwise provided in this paragraph (b), an applicable taxpayer is a taxpayer whose household income is at least 100 percent but not more than 400 percent of the Federal poverty line for the taxpayer's family size for the taxable year.

(2) *Married taxpayers must file joint return*—(i) *In general.* Except as provided in paragraph (b)(2)(ii) of this section, a taxpayer who is married (within the meaning of section 7703) at the close of the taxable year is an applicable taxpayer only if the taxpayer and the taxpayer's spouse file a joint return for the taxable year.

(ii) *Victims of domestic abuse and abandonment.* Except as provided in paragraph (b)(2)(v) of this section, a married taxpayer satisfies the joint filing requirement of paragraph (b)(2)(i) of this section if the taxpayer files a tax return using a filing status of married filing separately and the taxpayer—

(A) Is living apart from the taxpayer's spouse at the time the taxpayer files the tax return;

(B) Is unable to file a joint return because the taxpayer is a victim of domestic abuse, as described in paragraph (b)(2)(iii) of this section, or spousal abandonment, as described in paragraph (b)(2)(iv) of this section; and

(C) Certifies on the return, in accordance with the relevant instructions, that the taxpayer meets the criteria of this paragraph (b)(2)(ii).

(iii) *Domestic abuse.* For purposes of paragraph (b)(2)(ii) of this section, domestic abuse includes physical, psychological, sexual, or emotional abuse, including efforts to control, isolate, humiliate, and intimidate, or to undermine the victim's ability to reason independently. All the facts and circumstances are considered in determining whether an individual is abused, including the effects of alcohol or drug abuse by the victim's spouse. Depending on the facts and circumstances, abuse of the victim's child or another family member living in the household may constitute abuse of the victim.

(iv) *Abandonment.* For purposes of paragraph (b)(2)(ii) of this section, a taxpayer is a victim of spousal abandonment for a taxable year if, taking into account all facts and circumstances, the taxpayer is unable to locate his or her spouse after reasonable diligence.

(v) *Three-year rule.* Paragraph (b)(2)(ii) of this section does not apply if the taxpayer met the requirements of paragraph (b)(2)(ii) of this section for each of the three preceding taxable years.

(3) *Dependents.* An individual is not an applicable taxpayer if another taxpayer may claim a deduction under section 151 for the individual for a taxable year beginning in the calendar year in which the individual's taxable year begins.

(4) *Individuals not lawfully present or incarcerated.* An individual who is not lawfully present in the United States or is incarcerated (other than incarceration pending disposition of charges) is not eligible to enroll in a qualified health plan through an Exchange. However, the individual may be an applicable taxpayer if a family member is eligible to enroll in a qualified health plan. See sections 1312(f)(1)(B) and 1312(f)(3) of the Affordable Care Act (42 U.S.C. 18032(f)(1)(B) and (f)(3)) and §1.36B–3(b)(2).

(5) *Individuals lawfully present.* If a taxpayer's household income is less than 100 percent of the Federal poverty line for the taxpayer's family size and the taxpayer or a member of the taxpayer's family is an alien lawfully present in the United States, the taxpayer is treated as an applicable taxpayer if—

(i) The lawfully present taxpayer or family member is not eligible for the Medicaid program; and

(ii) The taxpayer would be an applicable taxpayer if the taxpayer's household income for the taxable year was between 100 and 400 percent of the Federal poverty line for the taxpayer's family size.

(6) *Special rule for taxpayers with household income below 100 percent of the Federal poverty line for the taxable year*—(i) *In general*. A taxpayer (other than a taxpayer described in paragraph (b)(5) of this section) whose household income for a taxable year is less than 100 percent of the Federal poverty line for the taxpayer's family size is treated as an applicable taxpayer for the taxable year if—

(A) The taxpayer or a family member enrolls in a qualified health plan through an Exchange for one or more months during the taxable year;

(B) An Exchange estimates at the time of enrollment that the taxpayer's household income will be at least 100 percent but not more than 400 percent of the Federal poverty line for the taxable year;

(C) Advance credit payments are authorized and paid for one or more months during the taxable year; and

(D) The taxpayer would be an applicable taxpayer if the taxpayer's household income for the taxable year was at least 100 but not more than 400 percent of the Federal poverty line for the taxpayer's family size.

(ii) *Exceptions*. This paragraph (b)(6) does not apply for an individual who, with intentional or reckless disregard for the facts, provides incorrect information to an Exchange for the year of coverage. A reckless disregard of the facts occurs if the taxpayer makes little or no effort to determine whether the information provided to the Exchange is accurate under circumstances that demonstrate a substantial deviation from the standard of conduct a reasonable person would observe. A disregard of the facts is intentional if the taxpayer knows the information provided to the Exchange is inaccurate.

(iii) Advance credit payments are authorized and paid for one or more months during the taxable year; and

(iv) The taxpayer would be an applicable taxpayer if the taxpayer's household income for the taxable year was between 100 and 400 percent of the Federal poverty line for the taxpayer's family size.

(7) *Computation of premium assistance amounts for taxpayers with household income below 100 percent of the Federal poverty line*. If a taxpayer is treated as an applicable taxpayer under paragraph (b)(5) or (b)(6) of this section, the taxpayer's actual household income for the taxable year is used to compute the premium assistance amounts under §1.36B–3(d).

(c) *Minimum essential coverage*—(1) *In general*. Minimum essential coverage is defined in section 5000A(f) and regulations issued under that section. As described in section 5000A(f), government-sponsored programs, eligible employer-sponsored plans, grandfathered health plans, and certain other health benefits coverage are minimum essential coverage.

(2) *Government-sponsored minimum essential coverage*—(i) *In general*. An individual is eligible for government-sponsored minimum essential coverage if the individual meets the criteria for coverage under a government-sponsored program described in section 5000A(f)(1)(A) as of the first day of the first full month the individual may receive benefits under the program, subject to the limitation in paragraph (c)(2)(ii) of this section. The Commissioner may define eligibility for specific government-sponsored programs further in additional published guidance, see §601.601(d)(2) of this chapter.

(ii) *Obligation to complete administrative requirements to obtain coverage*. An individual who meets the criteria for eligibility for government-sponsored minimum essential coverage must complete the requirements necessary to receive benefits. An individual who fails by the last day of the third full calendar month following the event that establishes eligibility under paragraph (c)(2)(i) of this section to complete the requirements to obtain government-sponsored minimum essential coverage (other than a veteran's health care program) is treated as eligible for government-sponsored minimum essential coverage as of the first day of the fourth calendar month following the event that establishes eligibility.

(iii) *Special rule for coverage for veterans and other individuals under chapter 17 or 18 of title 38, U.S.C.* An individual is eligible for minimum essential coverage under a health care program under chapter 17 or 18 of title 38, U.S.C. only if the individual is enrolled in a health care program under chapter 17 or 18 of title 38, U.S.C. identified as minimum essential coverage in regulations issued under section 5000A.

(iv) *Retroactive effect of eligibility determination.* If an individual receiving advance credit payments is determined to be eligible for government-sponsored minimum essential coverage that is effective retroactively (such as Medicaid), the individual is treated as eligible for minimum essential coverage under that program no earlier than the first day of the first calendar month beginning after the approval.

(v) *Determination of Medicaid or Children's Health Insurance Program (CHIP) ineligibility.* An individual is treated as not eligible for Medicaid, CHIP, or a similar program for a period of coverage under a qualified health plan if, when the individual enrolls in the qualified health plan, an Exchange determines or considers (within the meaning of 45 CFR 155.302(b)) the individual to be not eligible for Medicaid or CHIP. This paragraph (c)(2)(v) does not apply for an individual who, with intentional or reckless disregard for the facts, provides incorrect information to an Exchange for the year of coverage. A reckless disregard of the facts occurs if the taxpayer makes little or no effort to determine whether the information provided to the Exchange is accurate under circumstances that demonstrate a substantial deviation from the standard of conduct a reasonable person would observe. A disregard of the facts is intentional if the taxpayer knows that information provided to the Exchange is inaccurate.

(vi) *Examples.* The following examples illustrate the provisions of this paragraph (c)(2):

Example 1. Delay in coverage effectiveness. On April 10, 2015, Taxpayer D applies for coverage under a government-sponsored health care program. D's application is approved on July 12, 2015, but her coverage is not effective until September 1, 2015. Under paragraph (c)(2)(i) of this section, D is eligible for government-sponsored minimum essential coverage on September 1, 2015.

Example 2. Time of eligibility. Taxpayer E turns 65 on June 3, 2015, and becomes eligible for Medicare. Under section 5000A(f)(1)(A)(i), Medicare is minimum essential coverage. However, E must enroll in Medicare to receive benefits. E enrolls in Medicare in September, which is the last month of E's initial enrollment period. Thus, E may receive Medicare benefits on December 1, 2015. Because E completed the requirements necessary to receive Medicare benefits by the last day of the third full calendar month after the event that establishes E's eligibility (E turning 65), under paragraph (c)(2)(i) and (c)(2)(ii) of this section E is eligible for government-sponsored minimum essential coverage on December 1, 2015, the first day of the first full month that E may receive benefits under the program.

Example 3. Time of eligibility, individual fails to complete necessary requirements. The facts are the same as in *Example 2*, except that E fails to enroll in the Medicare coverage during E's initial enrollment period. E is treated as eligible for government-sponsored minimum essential coverage under paragraph (c)(2)(ii) of this section as of October 1, 2015, the first day of the fourth month following the event that establishes E's eligibility (E turning 65).

Example 4. Retroactive effect of eligibility. In November 2014, Taxpayer F enrolls in a qualified health plan for 2015 and receives advance credit payments. F loses her part-time employment and on April 10, 2015 applies for coverage under the Medicaid program. F's application is approved on May 15, 2015, and her Medicaid coverage is effective as of April 1, 2015. Under paragraph (c)(2)(iv) of this section, F is eligible for government-sponsored minimum essential coverage on June 1, 2015, the first day of the first calendar month after approval.

Example 5. Determination of Medicaid ineligibility. In November 2014, Taxpayer G applies through the Exchange to enroll in health coverage for 2015. The Exchange determines that G is not eligible for Medicaid and estimates that G's household income will be 140 percent of the Federal poverty line for G's family size for purposes of determining advance credit payments. G enrolls in a qualified health plan and begins receiving advance credit payments. G experiences a reduction in household income during the year and his household income for 2015 is 130 percent of the Federal poverty line (within the Medicaid income threshold). However, under paragraph (c)(2)(v) of this section, G is treated as not eligible for Medicaid for 2015.

Example 6. Mid-year Medicaid eligibility redetermination. The facts are the same as in *Example 5*, except that G returns to the Exchange in July 2015 and the Exchange determines that G is eligible for Medicaid. Medicaid approves G for coverage and the Exchange discontinues G's advance credit payments effective August 1. Under paragraphs (c)(2)(iv) and (c)(2)(v) of this section, G is treated as not eligible for Medicaid for the months when G is covered by a qualified health plan. G is eligible for government-sponsored minimum essential coverage for the months after G is approved for Medicaid and can receive benefits, August through December 2015.

(3) *Employer-sponsored minimum essential coverage*—(i) *In general*. For purposes of section 36B, an employee who may enroll in an eligible employer-sponsored plan (as defined in section 5000A(f)(2) and the regulations under that section) that is minimum essential coverage, and an individual who may enroll in the plan because of a relationship to the employee (a related individual), are eligible for minimum essential coverage under the plan for any month only if the plan is affordable and provides minimum value. Except for the Nonappropriated Fund Health Benefits Program of the Department of Defense, established under section 349 of the National Defense Authorization Act for Fiscal Year 1995 (Public Law 103–337; 10 U.S.C. 1587 note), government-sponsored minimum essential coverage is not an eligible employer-sponsored plan. The Nonappropriated Fund Health Benefits Program of the Department of Defense is considered eligible employer-sponsored coverage, but not government-sponsored coverage, for purposes of determining if an individual is eligible for minimum essential coverage under this section.

(ii) *Plan year*. For purposes of this paragraph (c)(3), a plan year is an eligible employer-sponsored plan's regular 12-month coverage period (or the remainder of a 12-month coverage period for a new employee or an individual who enrolls during a special enrollment period).

(iii) *Eligibility for months during a plan year*—(A) *Failure to enroll in plan*. An employee or related individual may be eligible for minimum essential coverage under an eligible employer-sponsored plan for a month during a plan year if the employee or related individual could have enrolled in the plan for that month during an open or special enrollment period for the plan year. If an enrollment period relates to coverage for not only the upcoming plan year (or the current plan year in the case of an enrollment period other than an open enrollment period), but also coverage in one or more succeeding plan years, this paragraph (c)(3)(iii)(A) applies only to eligibility for the coverage in the upcoming plan year (or the current plan year in the case of an enrollment period other than an open enrollment period).

(B) *Waiting periods*. An employee or related individual is not eligible for minimum essential coverage under an eligible employer-sponsored plan during a required waiting period before the coverage becomes effective.

(C) *Example*. The following example illustrates the provisions of this paragraph (c)(3)(iii):

Example. (i) Taxpayer B is an employee of Employer X. X offers its employees a health insurance plan that has a plan year (within the meaning of paragraph (c)(3)(ii) of this section) from October 1 through September 30. Employees may enroll during an open season from August 1 to September 15. B does not enroll in X's plan for the plan year October 1, 2014, to September 30, 2015. In November 2014, B enrolls in a qualified health plan through an Exchange for calendar year 2015.

(ii) B could have enrolled in X's plan during the August 1 to September 15 enrollment period. Therefore, unless X's plan is not affordable for B or does not provide minimum value, B is eligible for minimum essential coverage under X's plan for the months that B is enrolled in the qualified health plan during X's plan year (January through September 2015).

(iv) *Post-employment coverage*. A former employee (including a retiree), or an individual related (within the meaning of paragraph (c)(3)(i) of this section) to a former employee, who may enroll in eligible employer-sponsored coverage or in continuation coverage required under Federal law or a State law that provides comparable continuation coverage is eligible for minimum essential coverage under this coverage only for months that the former employee or related individual is enrolled in the coverage.

(v) *Affordable coverage*—(A) *In general*—(*1*) *Affordability for employee.* Except as provided in paragraph (c)(3)(v)(A)(*3*) of this section, an eligible employer-sponsored plan is affordable for an employee if the portion of the annual premium the employee must pay, whether by salary reduction or otherwise (required contribution), for self-only coverage does not exceed the required contribution percentage (as defined in paragraph (c)(3)(v)(C) of this section) of the applicable taxpayer's household income for the taxable year.

(*2*) *Affordability for related individual.* Except as provided in paragraph (c)(3)(v)(A)(*3*) of this section, an eligible employer-sponsored plan is affordable for a related individual if the portion of the annual premium the employee must pay for self-only coverage does not exceed the required contribution percentage, as described in paragraph (c)(3)(v)(A)(*1*) of this section.

(*3*) *Employee safe harbor.* An employer-sponsored plan is not affordable for an employee or a related individual for a plan year if, when the employee or a related individual enrolls in a qualified health plan for a period coinciding with the plan year (in whole or in part), an Exchange determines that the eligible employer-sponsored plan is not affordable for that plan year. This paragraph (c)(3)(v)(A)(*3*) does not apply to a determination made as part of the redetermination process described in 45 CFR 155.335 unless the individual receiving an Exchange redetermination notification affirmatively responds and provides current information on affordability. This paragraph (c)(3)(v)(A)(*3*) does not apply for an individual who, with intentional or reckless disregard for the facts, provides incorrect information to an Exchange concerning the portion of the annual premium for coverage for the employee or related individual under the plan. A reckless disregard of the facts occurs if the taxpayer makes little or no effort to determine whether the information provided to the Exchange is accurate under circumstances that demonstrate a substantial deviation from the standard of conduct a reasonable person would observe. A disregard of the facts is intentional if the taxpayer knows that the information provided to the Exchange is inaccurate.

(*4*) *Wellness program incentives.* Nondiscriminatory wellness program incentives offered by an eligible employer-sponsored plan that affect premiums are treated as earned in determining an employee's required contribution for purposes of affordability of an eligible employer-sponsored plan to the extent the incentives relate exclusively to tobacco use. Wellness program incentives that do not relate to tobacco use or that include a component unrelated to tobacco use are treated as not earned for this purpose. For purposes of this section, the term *wellness program incentive* has the same meaning as the term *reward* in § 54.9802–1(f)(1)(i) of this chapter.

(*5*) *Employer contributions to health reimbursement arrangements.* Amounts newly made available for the current plan year under a health reimbursement arrangement that an employee may use to pay premiums, or may use to pay cost-sharing or benefits not covered by the primary plan in addition to premiums, reduce the employee's required contribution if the health reimbursement arrangement would be integrated, as that term is used in Notice 2013–54 (2013–40 IRB 287) (see § 601.601(d) of this chapter), with an eligible employer-sponsored plan for an employee enrolled in the plan. The eligible employer-sponsored plan and the health reimbursement arrangement must be offered by the same employer. Employer contributions to a health reimbursement arrangement reduce an employee's required contribution only to the extent the amount of the annual contribution is required under the terms of the plan or otherwise determinable within a reasonable time before the employee must decide whether to enroll in the eligible employer-sponsored plan.

(*6*) *Employer contributions to cafeteria plans.* Amounts made available for the current plan year under a cafeteria plan, within the meaning of section 125, reduce an employee's or a related individual's required contribution if—

(*i*) The employee may not opt to receive the amount as a taxable benefit;

(*ii*) The employee may use the amount to pay for minimum essential coverage; and

(*iii*) The employee may use the amount exclusively to pay for medical care, within the meaning of section 213.

(*7*) *Opt-out arrangements.* [Reserved]

(B) *Affordability for part-year period.* Affordability under paragraph (c)(3)(v)(A) of this section is determined separately for each employment period that is less than a full calendar year or for the portions of an employer's plan year that fall in different taxable years of an applicable taxpayer (a part-year period). An eligible employer-sponsored plan is affordable for a part-year period if the employee's annualized required contribution for self-only coverage under the plan for the part-year period does not exceed the required contribution percentage of the applicable taxpayer's household income for the taxable year. The employee's annualized required contribution is the employee's required contribution for the part-year period times a fraction, the numerator of which is 12 and the denominator of which is the number of months in the part-year period during the applicable taxpayer's taxable year. Only full calendar months are included in the computation under this paragraph (c)(3)(v)(B).

(C) *Required contribution percentage.* The required contribution percentage is 9.5 percent. For plan years beginning in a calendar year after 2014, the percentage will be adjusted by the ratio of premium growth to income growth for the preceding calendar year and may be further adjusted to reflect changes to the data used to compute the ratio of premium growth to income growth for the 2014 calendar year or the data sources used to compute the ratio of premium growth to income growth. Premium growth and income growth will be determined under published guidance, see §601.601(d)(2) of this chapter. In addition, the percentage may be adjusted for plan years beginning in a calendar year after 2018 to reflect rates of premium growth relative to growth in the consumer price index.

(D) *Examples.* The following examples illustrate the provisions of this paragraph (c)(3)(v). Unless stated otherwise, in each example the taxpayer is single and has no dependents, the employer's plan is an eligible employer-sponsored plan and provides minimum value, the employee is not eligible for other minimum essential coverage, and the taxpayer, related individual, and employer-sponsored plan have a calendar taxable year:

Example 1. Basic determination of affordability. In 2014 Taxpayer C has household income of $47,000. C is an employee of Employer X, which offers its employees a health insurance plan that requires C to contribute $3,450 for self-only coverage for 2014 (7.3 percent of C's household income). Because C's required contribution for self-only coverage does not exceed 9.5 percent of household income, under paragraph (c)(3)(v)(A)(*1*) of this section, X's plan is affordable for C, and C is eligible for minimum essential coverage for all months in 2014.

Example 2. Basic determination of affordability for a related individual. The facts are the same as in *Example 1,* except that C is married to J and X's plan requires C to contribute $5,300 for coverage for C and J for 2014 (11.3 percent of C's household income). Because C's required contribution for self-only coverage ($3,450) does not exceed 9.5 percent of household income, under paragraph (c)(3)(v)(A)(*2*) of this section, X's plan is affordable for C and J, and C and J are eligible for minimum essential coverage for all months in 2014.

Example 3. Determination of unaffordability at enrollment. (i) Taxpayer D is an employee of Employer X. In November 2013 the Exchange for D's rating area projects that D's 2014 household income will be $37,000. It also verifies that D's required contribution for self-only coverage under X's health insurance plan will be $3,700 (10 percent of household income). Consequently, the Exchange determines that X's plan is unaffordable. D enrolls in a qualified health plan and not in X's plan. In December 2014, X pays D a $2,500 bonus. Thus, D's actual 2014 household income is $39,500 and D's required contribution for coverage under X's plan is 9.4 percent of D's household income.

(ii) Based on D's actual 2014 household income, D's required contribution does not exceed 9.5 percent of household income and X's health plan is affordable for D. However, when D enrolled in a qualified health plan for 2014, the Exchange determined that X's plan was not affordable for D for 2014. Consequently, under paragraph (c)(3)(v)(A)(*3*) of this section, X's plan is not affordable for D and D is not eligible for minimum essential coverage under X's plan for 2014.

Example 4. Determination of unaffordability for plan year. The facts are the same as in *Example 3,* except that X's employee health insurance plan year is September 1 to August

31. The Exchange for D's rating area determines in August 2014 that X's plan is unaffordable for D based on D's projected household income for 2014. D enrolls in a qualified health plan as of September 1, 2014. Under paragraph (c)(3)(v)(A)(*3*) of this section, X's plan is not affordable for D and D is not eligible for minimum essential coverage under X's plan for the coverage months September to December 2014 and January through August 2015.

Example 5. No affordability information affirmatively provided for annual redetermination. (i) The facts are the same as in *Example 3*, except the Exchange redetermines D's eligibility for advance credit payments for 2015. D does not affirmatively provide the Exchange with current information regarding affordability and the Exchange determines that D's coverage is not affordable for 2015 and approves advance credit payments based on information from the previous enrollment period. In 2015, D's required contribution for coverage under X's plan is 9.4 percent of D's household income.

(ii) Because D does not respond to the Exchange notification and the Exchange makes an affordability determination based on information from an earlier year, the employee safe harbor in paragraph (c)(3)(v)(A)(*3*) of this section does not apply. D's required contribution for 2015 does not exceed 9.5 percent of D's household income. Thus, X's plan is affordable for D for 2015 and D is eligible for minimum essential coverage for all months in 2015.

Example 6. Determination of unaffordability for part of plan year (part-year period). (i) Taxpayer E is an employee of Employer X beginning in May 2015. X's employee health insurance plan year is September 1 to August 31. E's required contribution for self-only coverage for May through August is $150 per month ($1,800 for the full plan year). The Exchange for E's rating area projects E's household income for purposes of eligibility for advance credit payments as $18,000. E's actual household income for the 2015 taxable year is $20,000.

(ii) Under paragraph (c)(3)(v)(B) of this section, whether coverage under X's plan is affordable for E is determined for the remainder of X's plan year (May through August). E's required contribution for a full plan year ($1,800) exceeds 9.5 percent of E's household income (1,800/18,000 = 10 percent). Therefore, the Exchange determines that X's coverage is unaffordable for May through August. Although E's actual household income for 2015 is $20,000 (and E's required contribution of $1,800 does not exceed 9.5 percent of E's household income), under paragraph (c)(3)(v)(A)(*3*) of this section, X's plan is unaffordable for E for the part of the plan year May through August 2015. Consequently, E is not eligible for minimum essential coverage under X's plan for the period May through August 2015.

Example 7. Affordability determined for part of a taxable year (part-year period). (i) Taxpayer F is an employee of Employer X. X's employee health insurance plan year is September 1 to August 31. F's required contribution for self-only coverage for the period September 2014 through August 2015 is $150 per month or $1,800 for the plan year. F does not enroll in X's plan during X's open season but enrolls in a qualified health plan for September through December 2014. F does not request advance credit payments and does not ask the Exchange for his rating area to determine whether X's coverage is affordable for F. F's household income in 2014 is $18,000.

(ii) Because F is a calendar year taxpayer and Employer X's plan is not a calendar year plan, F must determine the affordability of X's coverage for the part-year period in 2014 (September–December) under paragraph (c)(3)(v)(B) of this section. F determines the affordability of X's plan for the September through December 2014 period by comparing the annual premiums ($1,800) to F's 2014 household income. F's required contribution of $1,800 is 10 percent of F's 2014 household income. Because F's required contribution exceeds 9.5 percent of F's 2014 household income, X's plan is not affordable for F for the part-year period September through December 2014 and F is not eligible for minimum essential coverage under X's plan for that period.

(iii) F enrolls in Exchange coverage for 2015 and does not ask the Exchange to approve advance credit payments or determine whether X's coverage is affordable. F's 2015 household income is $20,000.

(iv) F must determine if X's plan is affordable for the part-year period January 2015 through August 2015. F's annual required contribution ($1,800) is 9 percent of F's 2015 household income. Because F's required contribution does not exceed 9.5 percent of F's 2015 household income, X's plan is affordable for F for the part-year period January through August 2015 and F is eligible for minimum essential coverage for that period.

Example 8. Coverage unaffordable at year end. Taxpayer G is employed by Employer X. In November 2014, the Exchange for G's rating area determines that G is eligible for affordable employer-sponsored coverage for 2015. G nonetheless enrolls in a qualified health plan for 2015 but does not receive advance credit payments. G's 2015 household income is less than expected and G's required contribution for employer-sponsored coverage for 2015 exceeds 9.5 percent of G's actual 2015 household income. Under paragraph (c)(3)(v)(A)(*1*) of this section, G is not eligible for minimum essential coverage under X's plan for 2015.

Example 9. Wellness program incentives. (i) Employer X offers an eligible employer-sponsored plan with a nondiscriminatory wellness program that reduces premiums by $300 for employees who do not use tobacco products or who complete a smoking cessation course. Premiums are reduced by $200 if an employee completes cholesterol screening within the first six months of the plan year. Employee B does not use tobacco and the cost of his premiums is $3,700. Employee C uses tobacco and the cost of her premiums is $4,000.

(ii) Under paragraph (c)(3)(v)(A)(*4*) of this section, only the incentives related to tobacco use are counted toward the premium amount used to determine the affordability of X's plan. C is treated as having earned the $300 incentive for attending a smoking cessation course regardless of whether C actually attends the course. Thus, the required contribution for determining affordability for both Employee B and Employee C is $3,700. The $200 incentive for completing cholesterol screening is treated as not earned and does not reduce their required contribution.

(vi) *Minimum value.* See §1.36B–6 for rules for determining whether an eligible employer-sponsored plan provides minimum value.

(vii) *Enrollment in eligible employer-sponsored plan*—(A) *In general.* Except as provided in paragraph (c)(3)(vii)(B) of this section, the requirements of affordability and minimum value do not apply for months that an individual is enrolled in an eligible employer-sponsored plan.

(B) *Automatic enrollment.* An employee or related individual is treated as not enrolled in an eligible employer-sponsored plan for a month in a plan year or other period for which the employee or related individual is automatically enrolled if the employee or related individual terminates the coverage before the later of the first day of the second full calendar month of that plan year or other period or the last day of any permissible opt-out period provided by the employer-sponsored plan or in regulations to be issued by the Department of Labor, for that plan year or other period.

(C) *Examples.* The following examples illustrate the provisions of this paragraph (c)(3)(vii):

Example 1. Taxpayer H is employed by Employer X in 2014. H's required contribution for self-only employer coverage exceeds 9.5 percent of H's 2014 household income. H enrolls in X's calendar year plan for 2014. Under paragraph (c)(3)(vii)(A) of this section, H is eligible for minimum essential coverage for 2014 because H is enrolled in an eligible employer-sponsored plan for 2014.

Example 2. The facts are the same as in *Example 1,* except that H terminates plan coverage on June 30, 2014. Under paragraph (c)(3)(vii)(A) of this section, H is eligible for minimum essential coverage under X's plan for January through June 2014 but is not eligible for minimum essential coverage under X's plan for July through December 2014.

Example 3. The facts are the same as in *Example 1,* except that Employer X automatically enrolls H in the plan for calendar year 2015. H terminates the coverage on January 20, 2015. Under paragraph (c)(3)(vii)(B) of this section, H is not eligible for minimum essential coverage under X's plan for January 2015.

(4) *Special eligibility rules*—(i) *Related individual not claimed as a personal exemption deduction.* An individual who may enroll in minimum essential coverage because of a relationship to another person eligible for the coverage, but for whom the other eligible person does not claim a personal exemption deduction under section 151, is treated as eligible for minimum essential coverage under the coverage only for months that the related individual is enrolled in the coverage.

(ii) *Exchange unable to discontinue advance credit payments*—(A) *In general.* If an individual who is enrolled in a qualified health plan for which advance credit payments are made informs the Exchange that the individual is or will soon be eligible for other minimum essential coverage and that advance credit payments should be discontinued, but the Exchange does not discontinue advance credit payments for the first calendar month beginning after the month the individual informs the Exchange, the individual is treated as eligible for the other minimum essential coverage no earlier than the first day of the second calendar month beginning after the first month the individual may enroll in the other minimum essential coverage.

(B) *Medicaid or CHIP.* If a determination is made that an individual who is enrolled in a qualified health plan for which advance credit payments are made is eligible for Medicaid or CHIP but the advance credit payments are not discontinued for the first calendar month beginning after the eligibility determination, the individual is treated as eligible for the Medicaid or CHIP no earlier than the first day of the second calendar month beginning after the eligibility determination.

(d) *Applicability date.* Paragraphs (b)(2) and (c)(3)(v)(C) of this section apply to taxable years beginning after December 31, 2013.

(e) *Effective/applicability date.* (1) Except as provided in paragraph (e)(2) of this section, this section applies to taxable years ending after December 31, 2013.

(2) Paragraph (b)(6)(ii), the last three sentences of paragraph (c)(2)(v), paragraph (c)(3)(i), paragraph (c)(3)(iii)(A), the last three sentences of paragraph (c)(3)(v)(A)(*3*), and paragraph (c)(4) of this section apply to taxable years beginning after December 31, 2016. Paragraphs (b)(6), (c)(3)(i), (c)(3)(iii)(A), and (c)(4) of §1.36B–2 as contained in 26 CFR part I edition revised as of April 1, 2016, apply to taxable years ending after December 31, 2013, and beginning before January 1, 2017.

[T.D. 9590, 77 FR 30385, May 23, 2012, as amended by T.D. 9611, 78 FR 7265, Feb. 1, 2013; T.D. 9683, 79 FR 43626, July 28, 2014; 80 FR 78974, Dec. 18, 2015; T.D. 9804, 81 FR 91764, Dec. 19, 2016; T.D. 9822, 82 FR 34606, July 26, 2017]

§ 1.36B–3 Computing the premium assistance credit amount.

(a) *In general.* A taxpayer's premium assistance credit amount for a taxable year is the sum of the premium assistance amounts determined under paragraph (d) of this section for all coverage months for individuals in the taxpayer's family.

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

(1) The cost of a qualified health plan is the premium the plan charges; and

(2) The term *coverage family* means, in each month, the members of a taxpayer's family for whom the month is a coverage month.

(c) *Coverage month*—(1) *In general.* A month is a coverage month for an individual if—

(i) As of the first day of the month, the individual is enrolled in a qualified health plan through an Exchange;

(ii) The taxpayer pays the taxpayer's share of the premium for the individual's coverage under the plan for the month by the unextended due date for filing the taxpayer's income tax return for that taxable year, or the full premium for the month is paid by advance credit payments; and

(iii) The individual is not eligible for the full calendar month for minimum essential coverage (within the meaning of §1.36B–2(c)) other than coverage described in section 5000A(f)(1)(C) (relating to coverage in the individual market).

(2) *Certain individuals enrolled during a month.* If an individual enrolls in a qualified health plan and the enrollment is effective on the date of the individual's birth, adoption, or placement for adoption or in foster care, or on the effective date of a court order, the individual is treated as enrolled as of the first day of that month for purposes of this paragraph (c).

(3) *Premiums paid for a taxpayer.* Premiums another person pays for coverage of the taxpayer, taxpayer's spouse, or dependent are treated as paid by the taxpayer.

(4) *Appeals of coverage eligibility.* A taxpayer who is eligible for advance credit payments pursuant to an eligibility appeal decision implemented under 45 CFR 155.545(c)(1)(ii) for coverage of a member of the taxpayer's coverage family who, based on the appeal decision, retroactively enrolls in a qualified health plan is considered to have met the requirement in paragraph (c)(1)(ii) of this section for a month if the taxpayer pays the taxpayer's share of the premiums for coverage under the plan for the month on or before the 120th day following the date of the appeals decision.

(5) *Examples.* The following examples illustrate the provisions of this paragraph (c):

Example 1. (i) Taxpayer M is single with no dependents. In December 2013, M enrolls in a qualified health plan for 2014 and the Exchange approves advance credit payments. M pays M's share of the premiums. On May 15, 2014, M enlists in the U.S. Army and is eligible immediately for government-sponsored minimum essential coverage.

(ii) Under paragraph (c)(1) of this section, January through May 2014 are coverage months for M. June through December 2014 are not coverage months because M is eligible for minimum essential coverage for those months. Thus, under paragraph (a) of this section, M's premium assistance credit amount for 2014 is the sum of the premium assistance amounts for the months January through May.

Example 2. (i) Taxpayer N has one dependent, S. S is eligible for government-sponsored minimum essential coverage. N is not eligible for minimum essential coverage. N enrolls in a qualified health plan for 2014 and the Exchange approves advance credit payments. On August 1, 2014, S loses eligibility for minimum essential coverage. N terminates enrollment in the qualified health plan that covers only N and enrolls in a qualified health plan that covers N and S for August through December 2014. N pays all premiums not covered by advance credit payments.

(ii) Under paragraph (c)(1) of this section, January through December of 2014 are coverage months for N and August through December are coverage months for N and S. N's premium assistance credit amount for 2014 is the sum of the premium assistance amounts for these coverage months.

Example 3. (i) O and P are the divorced parents of T. Under the divorce agreement between O and P, T resides with P and P claims T as a dependent. However, O must pay premiums for health insurance for T. P enrolls T in a qualified health plan for 2014. O pays the portion of T's qualified health plan premiums not covered by advance credit payments.

(ii) Because P claims T as a dependent, P (and not O) may claim a premium tax credit for coverage for T. See §1.36B–2(a). Under paragraph (c)(2) of this section, the premiums that O pays for coverage for T are treated as paid by P. Thus, the months when T is covered by a qualified health plan and not eligible for other minimum essential coverage are coverage months under paragraph (c)(1) of this section in computing P's premium tax credit under paragraph (a) of this section.

Example 4. Q, an American Indian, enrolls in a qualified health plan for 2014. Q's tribe pays the portion of Q's qualified health plan premiums not covered by advance credit payments. Under paragraph (c)(2) of this section, the premiums that Q's tribe pays for Q are treated as paid by Q. Thus, the months when Q is covered by a qualified health plan and not eligible for other minimum essential coverage are coverage months under paragraph (c)(1) of this section in computing Q's premium tax credit under paragraph (a) of this section.

(d) *Premium assistance amount*—(1) *Premium assistance amount.* The premium assistance amount for a coverage month is the lesser of—

(i) The premiums for the month, reduced by any amounts that were refunded, for one or more qualified health plans in which a taxpayer or a member of the taxpayer's family enrolls (enrollment premiums); or

(ii) The excess of the adjusted monthly premium for the applicable benchmark plan (benchmark plan premium) over $\frac{1}{12}$ of the product of a taxpayer's household income and the applicable percentage for the taxable year (the taxpayer's contribution amount).

(2) *Examples.* The following examples illustrate the rules of paragraph (d)(1) of this section.

Example 1. Taxpayer Q is single and has no dependents. Q enrolls in a qualified health plan with a monthly premium of $400. Q's monthly benchmark plan premium is $500, and his monthly contribution amount is $80. Q's premium assistance amount for a coverage month is $400 (the lesser of $400, Q's monthly enrollment premium, and $420, the difference between Q's monthly benchmark plan premium and Q's contribution amount).

Example 2. (i) Taxpayer R is single and has no dependents. R enrolls in a qualified health plan with a monthly premium of $450. The difference between R's benchmark plan premium and contribution amount for the month is $420.

(ii) The issuer of R's qualified health plan is notified that R died on September 20. The issuer terminates coverage as of that date and refunds the remaining portion of the September enrollment premiums ($150) for R's coverage.

(iii) R's premium assistance amount for each coverage month from January through August is $420 (the lesser of $450 and $420). Under paragraph (d)(1) of this section, R's premium assistance amount for September is the lesser of the enrollment premiums for the month, reduced by any amounts that were refunded ($300 ($450–$150)) or the difference between the benchmark plan premium and the contribution amount for the month ($420). R's premium assistance amount for September is $300, the lesser of $420 and $300.

Example 3. The facts are the same as in *Example 2* of this paragraph (d)(2), except that the qualified health plan issuer does not refund any enrollment premiums for September. Under paragraph (d)(1) of this section, R's premium assistance amount for September is $420, the lesser of $450 and $420.

(e) *Adjusted monthly premium.* The adjusted monthly premium is the premium an issuer would charge for the applicable benchmark plan to cover all members of the taxpayer's coverage family, adjusted only for the age of each member of the coverage family as allowed under section 2701 of the Public Health Service Act (42 U.S.C. 300gg). The adjusted monthly premium is determined without regard to any premium discount or rebate under the wellness discount demonstration project under section 2705(d) of the Public Health Service Act (42 U.S.C. 300gg-4(d)) and may not include any adjustments for tobacco use. The adjusted monthly premium for a coverage month is determined as of the first day of the month.

(f) *Applicable benchmark plan*—(1) *In general*. Except as otherwise provided in this paragraph (f), the applicable benchmark plan for each coverage month is the second-lowest-cost silver plan (as described in section 1302(d)(1)(B) of the Affordable Care Act (42 U.S.C. 18022(d)(1)(B))) offered to the taxpayer's coverage family through the Exchange for the rating area where the taxpayer resides for—

(i) Self-only coverage for a taxpayer—

(A) Who computes tax under section 1(c) (unmarried individuals other than surviving spouses and heads of household) and is not allowed a deduction under section 151 for a dependent for the taxable year;

(B) Who purchases only self-only coverage for one individual; or

(C) Whose coverage family includes only one individual; and

(ii) Family coverage for all other taxpayers.

(2) *Family coverage*. The applicable benchmark plan for family coverage is the second lowest-cost silver plan that would cover the members of the taxpayer's coverage family (such as a plan covering two adults if the members of a taxpayer's coverage family are two adults).

(3) *Silver-level plan not covering pediatric dental benefits*. If one or more silver-level qualified health plans offered through an Exchange do not cover pediatric dental benefits, the premium for the applicable benchmark plan is determined based on the second lowest-cost option among—

(i) The silver-level qualified health plans that are offered by the Exchange to the members of the coverage family and that provide pediatric dental benefits; and

(ii) The silver-level qualified health plans that are offered by the Exchange to the members of the coverage family that do not provide pediatric dental benefits in conjunction with the second lowest-cost portion of the premium for a stand-alone dental plan (within the meaning of section 1311(d)(2)(B)(ii) of the Affordable Care Act (42 U.S.C. 18031(d)(2)(B)(ii)) offered by the Exchange to the members of the coverage family that is properly allocable to pediatric dental benefits determined under guidance issued by the Secretary of Health and Human Services.

(4) *Family members residing in different locations*. If members of a taxpayer's coverage family reside in different locations, the taxpayer's benchmark plan premium is the sum of the premiums for the applicable benchmark plans for each group of coverage family members residing in different locations, based on the plans offered to the group through the Exchange where the group resides. If all members of a taxpayer's coverage family reside in a single location that is different from where the taxpayer resides, the taxpayer's benchmark plan premium is the premium for the applicable benchmark plan for the coverage family, based on the plans offered through the Exchange to the taxpayer's coverage family for the rating area where the coverage family resides.

(5) *Single or multiple policies needed to cover the family*—(i) *Policy covering a taxpayer's family*. If a silver-level plan or a stand-alone dental plan offers coverage to all members of a taxpayer's coverage family who reside in the same location under a single policy, the premium (or allocable portion thereof, in the case of a stand-alone dental plan) taken into account for the plan for purposes of determining the applicable benchmark plan under paragraphs (f)(1), (f)(2), and (f)(3) of this section is the premium for this single policy.

(ii) *Policy not covering a taxpayer's family*. If a silver-level qualified health plan or a stand-alone dental plan would require multiple policies to cover all members of a taxpayer's coverage family who reside in the same location (for example, because of the relationships within the family), the premium (or allocable portion thereof, in the case of a standalone dental plan) taken into account for the plan for purposes of determining the applicable benchmark plan under paragraphs (f)(1), (f)(2), and (f)(3) of this section is the sum of the premiums (or allocable portion thereof, in the case of a stand-alone dental plan) for self-only policies under the plan for each member of the coverage family who resides in the same location.

(6) *Plan not available for enrollment.* A silver-level qualified health plan or a stand-alone dental plan that is not open to enrollment by a taxpayer or family member at the time the taxpayer or family member enrolls in a qualified health plan is disregarded in determining the applicable benchmark plan.

(7) *Benchmark plan terminates or closes to enrollment during the year.* A silver-level qualified health plan or a stand-alone dental plan that is used for purposes of determining the applicable benchmark plan under this paragraph (f) for a taxpayer does not cease to be the applicable benchmark plan for a taxable year solely because the plan or a lower cost plan terminates or closes to enrollment during the taxable year.

(8) *Only one silver-level plan offered to the coverage family.* If there is only one silver-level qualified health plan or one stand-alone dental plan offered through an Exchange that would cover all members of a taxpayer's coverage family who reside in the same location (whether under one policy or multiple policies), that plan is used for purposes of determining the taxpayer's applicable benchmark plan.

(9) *Examples.* The following examples illustrate the rules of this paragraph (f). Unless otherwise stated, in each example the plans are open to enrollment to a taxpayer or family member at the time of enrollment and are offered through the Exchange for the rating area where the taxpayer resides:

Example 1. Single taxpayer enrolls in Exchange coverage. Taxpayer A is single, has no dependents, and enrolls in a qualified health plan. The Exchange in the rating area in which A resides offers only silver-level qualified health plans that provide pediatric dental benefits. Under paragraphs (f)(1) and (f)(2) of this section, A's applicable benchmark plan is the second lowest cost silver plan providing self-only coverage for A.

Example 2. Single taxpayer enrolls with dependent child through an Exchange where all qualified health plans provide pediatric dental benefits. Taxpayer B is single and claims her 12-year old daughter, C, as a dependent. B purchases family coverage for herself and C. The Exchange in the rating area in which B and C reside offers qualified health plans that provide pediatric dental benefits but does not offer qualified health plans without pediatric dental benefits. Under paragraphs (f)(1) and (f)(2) of this section, B's applicable benchmark plan is the second lowest-cost silver plan providing family coverage to B and C.

Example 3. Single taxpayer enrolls with dependent child through an Exchange where one or more qualified health plans do not provide pediatric dental benefits. (i) Taxpayer D is single and claims his 10-year old son, E, as a dependent. The Exchange in the rating area in which D and E reside offers three silver-level qualified health plans, one of which provides pediatric dental benefits (S1) and two of which do not (S2 and S3), in which D and E may enroll. The Exchange also offers two stand-alone dental plans (DP1 and DP2) available to D and E. The monthly premiums allocable to essential health benefits for the silver-level plans are as follows:

S1—$650
S2—$620
S3—$590

(ii) The monthly premiums, and the portion of the premium allocable to pediatric dental benefits, for the two dental plans are as follows:

DP1—$50 ($20 allocable to pediatric dental benefits)
DP2—$40 ($15 allocable to pediatric dental benefits).

(iii) Under paragraph (f)(3) of this section, D's applicable benchmark plan is the second lowest cost option among the following offered by the rating area in which D resides: Silver-level qualified health plans providing pediatric dental benefits ($650 for S1) and the silver-level qualified health plans not providing pediatric dental benefits, in conjunction with the second lowest-cost portion of the premium for a stand-alone dental plan properly allocable to pediatric dental benefits ($590 for S3 in conjunction with $20 for DP1 = $610 and $620 for S2 in conjunction with $20 for DP1 = $640). Under paragraph (e) of this section, the adjusted monthly premium for D's applicable benchmark plan is $640.

Example 4. Single taxpayer enrolls with dependent adult through an Exchange where one or more qualified health plans do not provide pediatric dental benefits. (i) The facts are the same as in *Example 3*, except Taxpayer D's coverage family consists of D and D's 22-year old son, F, who is a dependent of D. The monthly premiums allocable to essential health benefits for the silver-level plans are as follows:

S1—$630

S2—$590

S3—$580

(ii) Because no one in D's coverage family is eligible for pediatric dental benefits, $0 of the premium for a stand-alone dental plan is allocable to pediatric dental benefits in determining A's applicable benchmark plan. Consequently, under paragraphs (f)(1), (f)(2), and (f)(3) of this section, D's applicable benchmark plan is the second lowest-cost option among the following options offered by the rating area in which D resides: Silver-level qualified health plans providing pediatric dental benefits ($630 for S1) and the silver-level qualified health plans not providing pediatric dental benefits, in conjunction with the second lowest-cost portion of the premium for a stand-alone dental plan properly allocable to pediatric dental benefits ($580 for S3 in conjunction with $0 for DP1 = $580 and $590 for S2 in conjunction with $0 for DP1 = $590). Under paragraph (e) of this section, the adjusted monthly premium for D's applicable benchmark plan is $590.

Example 5. Single taxpayer enrolls with dependent and nondependent. Taxpayer G is single and resides with his 25-year old daughter, H, and with his 14-year old son, I. G may claim I, but not H, as a dependent. G, H, and I enroll in coverage through the Exchange in the rating area in which they all reside. The Exchange offers only silver-level plans providing pediatric dental benefits. Under paragraphs (f)(1) and (f)(2) of this section, G's applicable benchmark plan is the second lowest-cost silver plan covering G and I. However, H may qualify for a premium tax credit if H is otherwise eligible. See paragraph (h) of this section.

Example 6. Change in coverage family. Taxpayer J is single and has no dependents when she enrolls in a qualified health plan. The Exchange in the rating area in which she resides offers only silver-level plans that provide pediatric dental benefits. On August 1, J has a child, K, whom she claims as a dependent. J enrolls in a qualified health plan covering J and K effective August 1. Under paragraphs (f)(1) and (f)(2) of this section, J's applicable benchmark plan for January through July is the second lowest-cost silver plan providing self-only coverage for J, and J's applicable benchmark plan for the months August through December is the second lowest-cost silver plan covering J and K.

Example 7. Minimum essential coverage for some coverage months. Taxpayer L claims his 6-year old daughter, M, as a dependent. L and M are enrolled for the entire year in a qualified health plan that offers only silver-level plans that provide pediatric dental benefits. L, but not M, is eligible for government-sponsored minimum essential coverage for September to December. Thus, under paragraph (c)(1)(iii) of this section, January through December are coverage months for M, and January through August are coverage months for L. Because, under paragraphs (d) and (f)(1) of this section, the premium assistance amount for a coverage month is computed based on the applicable benchmark plan for that coverage month, L's applicable benchmark plan for January through August is the second lowest-cost option covering L and M. Under paragraph (f)(1)(i)(C) of this section, L's applicable benchmark plan for September through December is the second lowest-cost silver plan providing self-only coverage for M.

Example 8. Family member eligible for minimum essential coverage for the taxable year. The facts are the same as in *Example 7*, except that L is not eligible for government-sponsored minimum essential coverage for any months and M is eligible for government sponsored minimum essential coverage for the entire year. Under paragraph (f)(1)(i)(C) of this section, L's applicable benchmark plan is the second lowest-cost silver plan providing self-only coverage for L.

Example 9. Benchmark plan premium for a coverage family with family members who reside in different locations. (i) Taxpayer N's coverage family consists of N and her three dependents O, P, and Q. N, O, and P reside together but Q resides in a different location. The monthly applicable benchmark plan premium for N, O, and P is $1,000 and the monthly applicable benchmark plan premium for Q is $220.

(ii) Under paragraph (f)(4) of this section, because the members of N's coverage family reside in different locations, the monthly premium for N's applicable benchmark plan is the sum of $1,000, the monthly premiums for the applicable benchmark plan for N, O, and P, who reside together, and $220, the monthly applicable benchmark plan premium for Q, who resides in a different location than N, O, and P. Consequently, the premium for N's applicable benchmark plan is $1,220.

Example 10. Aggregation of silver-level policies for plans not covering a family under a single policy. (i) Taxpayers R and S are married and live with S's mother, T, whom they claim as a dependent. The Exchange for their rating area offers self-only and family coverage at the silver level through Issuers A, B, and C, which each offer only one silver-level plan. The silver-level plans offered by Issuers A and B do not cover R, S, and T under a single policy. The silver-level plan offered by Issuer A costs the following monthly amounts for self-only coverage of R, S, and T, respectively: $400, $450, and $600. The silver-level plan offered by Issuer B costs the following monthly amounts for self-only coverage of R, S, and T, respectively: $250, $300, and $450.

The silver-level plan offered by Issuer C provides coverage for R, S, and T under one policy for a $1,200 monthly premium.

(ii) Under paragraph (f)(5) of this section, Issuer C's silver-level plan that covers R, S, and T under one policy ($1,200 monthly premium) and Issuer A's and Issuer B's silver-level plans that do not cover R, S and T under one policy are considered in determining R's and S's applicable benchmark plan. In addition, under paragraph (f)(5)(ii) of this section, in determining R's and S's applicable benchmark plan, the premium taken into account for Issuer A's plan is $1,450 (the aggregate premiums for self-only policies covering R ($400), S ($450), and T ($600) and the premium taken into account for Issuer B's plan is $1,000 (the aggregate premiums for self-only policies covering R ($250), S ($300), and T ($450). Consequently, R's and S's applicable benchmark plan is the Issuer C silver-level plan covering R's and S's coverage family and the premium for their applicable benchmark plan is $1,200.

Example 11. Benchmark plan premium for a taxpayer with family members who cannot enroll in one policy and who reside in different locations. (i) Taxpayer U's coverage family consists of U, U's mother, V, and U's two daughters, W and X. U and V reside together in Location 1 and W and X reside together in Location 2. The Exchange in the rating area in which U and V reside does not offer a silver-level plan that covers U and V under a single policy, whereas all the silver-level plans offered through the Exchange in the rating area in which W and X reside cover W and X under a single policy. Both Exchanges offer only silver-level plans that provide pediatric dental benefits. The silver plan offered by the Exchange for the rating area in which U and V reside that would cover U and V under self-only policies with the second-lowest aggregate premium costs $400 a month for self-only coverage for U and $600 a month for self-only coverage for V. The monthly premium for the second-lowest cost silver plan covering W and X that is offered by the Exchange for the rating area in which W and X reside is $500.

(ii) Under paragraph (f)(5)(ii) of this section, because multiple policies are required to cover U and V, the members of U's coverage family who reside together in Location 1, the premium taken into account in determining U's benchmark plan is $1,000, the sum of the premiums for the second-lowest aggregate cost of self-only policies covering U ($400) and V ($600) offered by the Exchange to U and V for the rating area in which U and V reside. Under paragraph (f)(5)(i) of this section, because all silver-level plans offered by the Exchange in which W and X reside cover W and X under a single policy, the premium for W and X's coverage that is taken into account in determining U's benchmark plan is $500, the second-lowest cost silver policy covering W and X that is offered by the Exchange for the rating area in which W and X reside. Under paragraph (f)(4) of this section, because the members of U's coverage family reside in different locations, U's monthly benchmark plan premium is $1,500, the sum of the premiums for the applicable benchmark plans for each group of family members residing in different locations ($1,000 for U and V, who reside in Location 1, plus $500 for W and X, who reside in Location 2).

Example 12. Qualified health plan closed to enrollment. Taxpayer Y has two dependents, Z and AA. Y, Z, and AA enroll in a qualified health plan through the Exchange for the rating area where the family resides. The Exchange, which offers only qualified health plans that include pediatric dental benefits, offers silver-level plans J, K, L, and M, which are, respectively, the first, second, third, and fourth lowest cost silver plans covering Y's family. When Y's family enrolls, Plan J is closed to enrollment. Under paragraph (f)(6) of this section, Plan J is disregarded in determining Y's applicable benchmark plan, and Plan L is used in determining Y's applicable benchmark plan.

Example 13. Benchmark plan closes to new enrollees during the year. (i) Taxpayers BB, CC, and DD each have coverage families consisting of two adults. In that rating area, Plan 2 is the second lowest cost silver plan and Plan 3 is the third lowest cost silver plan covering the two adults in each coverage family offered through the Exchange. The BB and CC families each enroll in a qualified health plan that is not the applicable benchmark plan (Plan 4) in November during the annual open enrollment period. Plan 2 closes to new enrollees the following June. Thus, on July 1, Plan 3 is the second lowest cost silver plan available to new enrollees through the Exchange. The DD family enrolls in a qualified health plan in July.

(ii) Under paragraphs (f)(1), (f)(2), (f)(3), and (f)(7) of this section, the silver-level plan that BB and CC use to determine their applicable benchmark plan for all coverage months during the year is Plan 2. The applicable benchmark plan that DD uses to determine DD's applicable benchmark plan is Plan 3, because Plan 2 is not open to enrollment through the Exchange when the DD family enrolls.

Example 14. Benchmark plan terminates for all enrollees during the year. The facts are the same as in *Example 13*, except that Plan 2 terminates for all enrollees on June 30. Under paragraphs (f)(1), (f)(2), (f)(3), and (f)(7) of this section, Plan 2 is the silver-level plan that BB and CC use to determine their applicable benchmark plan for all coverage months during the year, and Plan 3 is the applicable benchmark plan that DD uses.

Example 15. Exchange offers only one silver-level plan. Taxpayer EE's coverage family consists of EE, his spouse FF, and their two dependent children GG and HH, who all reside together. The Exchange for the rating area in which they reside offers only one silver-level plan that EE's family may enroll in and the plan does not provide pediatric dental benefits. The Exchange also offers one stand-alone dental plan in which the family may enroll. Under paragraph (f)(8) of this section, the silver-level plan and the stand-alone dental plan offered by the Exchange are used for purposes of determining EE's applicable benchmark plan under paragraph (f)(3) of this section. Moreover, the lone silver-level plan and the lone stand-alone dental plan offered by the Exchange are used for purposes of determining EE's applicable benchmark plan regardless of whether these plans cover EE's family under a single policy or multiples policies.

(g) *Applicable percentage*—(1) *In general.* The applicable percentage multiplied by a taxpayer's household income determines the taxpayer's annual required share of premiums for the benchmark plan. The required share is divided by 12 and this monthly amount is subtracted from the adjusted monthly premium for the applicable benchmark plan when computing the premium assistance amount. The applicable percentage is computed by first determining the percentage that the taxpayer's household income bears to the Federal poverty line for the taxpayer's family size. The resulting Federal poverty line percentage is then compared to the income categories described in the table in paragraph (g)(2) of this section. An applicable percentage within an income category increases on a sliding scale in a linear manner and is rounded to the nearest one-hundredth of one percent. For taxable years beginning after December 31, 2014, the applicable percentages in the table will be adjusted by the ratio of premium growth to income growth for the preceding calendar year and may be further adjusted to reflect changes to the data used to compute the ratio of premium growth to income growth for the 2014 calendar year or the data sources used to compute the ratio of premium growth to income growth. Premium growth and income growth will be determined in accordance with published guidance, see §601.601(d)(2) of this chapter. In addition, the applicable percentages in the table may be adjusted for taxable years beginning after December 31, 2018, to reflect rates of premium growth relative to growth in the consumer price index.

(2) *Applicable percentage table.*

Household income percentage of Federal poverty line	Initial percentage	Final percentage
Less than 133%	2.0	2.0
At least 133% but less than 150%	3.0	4.0
At least 150% but less than 200%	4.0	6.3
At least 200% but less than 250%	6.3	8.05
At least 250% but less than 300%	8.05	9.5
At least 300% but not more than 400%	9.5	9.5

(3) *Examples.* The following examples illustrate the rules of this paragraph (g):

Example 1. A's household income is 275 percent of the Federal Poverty line for A's family size for that taxable year. In the table in paragraph (g)(2) of this section, the initial percentage for a taxpayer with household income of 250 to 300 percent of the Federal poverty line is 8.05 and the final percentage is 9.5. A's Federal poverty line percentage of 275 percent is halfway between 250 percent and 300 percent. Thus, rounded to the nearest one-hundredth of one percent, A's applicable percentage is 8.78, which is halfway between the initial percentage of 8.05 and the final percentage of 9.5.

Example 2. (i) B's household income is 210 percent of the Federal poverty line for B's family size. In the table in paragraph (g)(2) of this section, the initial percentage for a taxpayer with household income of 200 to 250 percent of the Federal poverty line is 6.3 and the final percentage is 8.05. B's applicable percentage is 6.65, computed as follows.

(ii) Determine the excess of B's Federal poverty line percentage (210) over the initial household income percentage in B's range (200), which is 10. Determine the difference between the initial household income percentage in the taxpayer's range (200) and the ending household income percentage in the taxpayer's range (250), which is 50. Divide the first amount by the second amount:

$210 - 200 = 10$
$250 - 200 = 50$
$10 / 50 = .20$

(iii) Compute the difference between the initial premium percentage (6.3) and the second premium percentage (8.05) in the taxpayer's range; $8.05 - 6.3 = 1.75$.

(iv) Multiply the amount in the first calculation (.20) by the amount in the second calculation (1.75) and add the product (.35) to the initial premium percentage in B's range (6.3), resulting in B's applicable percentage of 6.65:

$.20 \times 1.75 = .35$

$6.3 + .35 = 6.65$.

(h) *Plan covering more than one family*—(1) *In general.* If a qualified health plan covers more than one family under a single policy, each applicable taxpayer covered by the plan may claim a premium tax credit, if otherwise allowable. Each taxpayer computes the credit using that taxpayer's applicable percentage, household income, and the benchmark plan that applies to the taxpayer under paragraph (f) of this section. In determining whether the amount computed under paragraph (d)(1)(i) of this section (the premiums for the qualified health plan in which the taxpayer enrolls) is less than the amount computed under paragraph (d)(1)(ii) of this section (the benchmark plan premium minus the product of household income and the applicable percentage), the premiums paid are allocated to each taxpayer in proportion to the premiums for each taxpayer's applicable benchmark plan.

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

Example. (i) Taxpayers A and B enroll in a single policy under a qualified health plan. B is A's 25-year old child who is not A's dependent. B has no dependents. The plan covers A, B, and A's two additional children who are A's dependents. The premium for the plan in which A and B enroll is $15,000. The premium for the second lowest cost silver family plan covering only A and A's dependents is $12,000 and the premium for the second lowest cost silver plan providing self-only coverage to B is $6,000. A and B are applicable taxpayers and otherwise eligible to claim the premium tax credit.

(ii) Under paragraph (h)(1) of this section, both A and B may claim premium tax credits. A computes her credit using her household income, a family size of three, and a benchmark plan premium of $12,000. B computes his credit using his household income, a family size of one, and a benchmark plan premium of $6,000.

(iii) In determining whether the amount in paragraph (d)(1)(i) of this section (the premiums for the qualified health plan A and B purchase) is less than the amount in paragraph (d)(1)(ii) of this section (the benchmark plan premium minus the product of household income and the applicable percentage), the $15,000 premiums paid are allocated to A and B in proportion to the premiums for their applicable benchmark plans. Thus, the portion of the premium allocated to A is $10,000 ($15,000 × $12,000/$18,000) and the portion allocated to B is $5,000 ($15,000 × $6,000/$18,000).

(i) [Reserved]

(j) *Additional benefits*—(1) *In general.* If a qualified health plan offers benefits in addition to the essential health benefits a qualified health plan must provide under section 1302 of the Affordable Care Act (42 U.S.C. 18022), or a State requires a qualified health plan to cover benefits in addition to these essential health benefits, the portion of the premium for the plan properly allocable to the additional benefits is excluded from the monthly premiums under paragraph (d)(1)(i) or (ii) of this section. Premiums are allocated to additional benefits before determining the applicable benchmark plan under paragraph (f) of this section.

(2) *Method of allocation.* The portion of the premium properly allocable to additional benefits is determined under guidance issued by the Secretary of Health and Human Services. See section 36B(b)(3)(D).

(3) *Examples.* The following examples illustrate the rules of this paragraph (j):

Example 1. (i) Taxpayer B enrolls in a qualified health plan that provides benefits in addition to essential health benefits (additional benefits). The monthly premiums for the plan in which B enrolls are $370, of which $35 is allocable to additional benefits. B's benchmark plan premium (determined after allocating premiums to additional benefits for all silver level plans) is $440, of which $40 is allocable to additional benefits. B's monthly contribution amount, which is the product of B's household income and the applicable percentage, is $60.

(ii) Under this paragraph (j), B's enrollment premiums and the benchmark plan premium are reduced by the portion of the premium that is allocable to the additional benefits provided under that plan. Therefore, B's monthly enrollment premiums are reduced to $335 ($370 − $35) and B's benchmark plan premium is reduced to $400 ($440 − $40). B's premium assistance amount for a coverage month is $335, the lesser of $335 (B's enrollment premiums, reduced by the portion of the premium allocable to additional benefits) and $340 (B's benchmark plan premium, reduced by the portion of the premium allocable to additional benefits ($400), minus B's $60 contribution amount).

Example 2. The facts are the same as in *Example 1* of this paragraph (j)(3), except that the plan in which B enrolls provides no benefits in addition to the essential health benefits required to be provided by the plan. Thus, under paragraph (j) of this section, B's benchmark plan premium ($440) is reduced by the portion of the premium allocable to additional benefits provided under that plan ($40). B's enrollment premiums ($370) are not reduced under this paragraph (j). B's premium assistance amount for a coverage month is $340, the lesser of $370 (B's enrollment premiums) and $340 (B's benchmark plan premium, reduced by the portion of the premium allocable to additional benefits ($400), minus B's $60 contribution amount).

(k) *Pediatric dental coverage*—(1) *In general.* For purposes of determining the amount of the monthly premium a taxpayer pays for coverage under paragraph (d)(1)(i) of this section, if an individual enrolls in both a qualified health plan and a plan described in section 1311(d)(2)(B)(ii) of the Affordable Care Act (42 U.S.C. 13031(d)(2)(B)(ii)) (a stand-alone dental plan), the portion of the premium for the stand-alone dental plan that is properly allocable to pediatric dental benefits that are essential benefits required to be provided by a qualified health plan is treated as a premium payable for the individual's qualified health plan.

(2) *Method of allocation.* The portion of the premium for a stand-alone dental plan properly allocable to pediatric dental benefits is determined under guidance issued by the Secretary of Health and Human Services.

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

Example. (i) Taxpayer C and C's dependent, R, enroll in a qualified health plan. The premium for the plan in which C and R enroll is $7,200 ($600/month) (Amount 1). The plan does not provide dental coverage. C also enrolls in a stand-alone dental plan covering C and R. The portion of the premium for the dental plan allocable to pediatric dental benefits that are essential health benefits is $240 ($20 per month). The excess of the premium for C's applicable benchmark plan over C's contribution amount (the product of C's household income and the applicable percentage) is $7,260 ($605/month) (Amount 2).

(ii) Under this paragraph (k), the amount C pays for premiums (Amount 1) for purposes of computing the premium assistance amount is increased by the portion of the premium for the stand-alone dental plan allocable to pediatric dental benefits that are essential health benefits. Thus, the amount of the premiums for the plan in which C enrolls is treated as $620 for purposes of computing the amount of the premium tax credit. C's premium assistance amount for each coverage month is $605 (Amount 2), the lesser of Amount 1 (increased by the premiums allocable to pediatric dental benefits) and Amount 2.

(l) *Families including individuals not lawfully present*—(1) *In general.* If one or more individuals for whom a taxpayer is allowed a deduction under section 151 are not lawfully present (within the meaning of § 1.36B–1(g)), the percentage a taxpayer's household income bears to the Federal poverty line for the taxpayer's family size for purposes of determining the applicable percentage under paragraph (g) of this section is determined by excluding individuals who are not lawfully present from family size and by determining household income in accordance with paragraph (l)(2) of this section.

(2) *Revised household income computation*—(i) *Statutory method.* For purposes of paragraph (l)(1) of this section, household income is equal to the product of the taxpayer's household income (determined without regard to this paragraph (l)(2)) and a fraction—

(A) The numerator of which is the Federal poverty line for the taxpayer's family size determined by excluding individuals who are not lawfully present; and

(B) The denominator of which is the Federal poverty line for the taxpayer's family size determined by including individuals who are not lawfully present.

(ii) *Comparable method.* The Commissioner may describe a comparable method in additional published guidance, see § 601.601(d)(2) of this chapter.

(m) *Applicability date.* Paragraph (g)(1) of this section applies to taxable years beginning after December 31, 2013.

(n) *Effective/applicability date.* (1) Except as provided in paragraph (n)(2) of this section, this section applies to taxable years ending after December 31, 2013.

(2) Paragraphs (c)(4), (d)(1) and (d)(2) of this section apply to taxable years beginning after December 31, 2016. Paragraph (f) of this section applies to taxable years beginning after December 31, 2018. Paragraphs (d)(1) and (d)(2) of §1.36B–3, as contained in 26 CFR part I edition revised as of April 1, 2016, applies to taxable years ending after December 31, 2013, and beginning before January 1, 2017. Paragraph (f) of §1.36B–3, as contained in 26 CFR part I edition revised as of April 1, 2016, applies to taxable years ending after December 31, 2013, and beginning before January 1, 2019.

[T.D. 9590, 77 FR 30385, May 23, 2012; 77 FR 41048, July 12, 2012; T.D. 9683, 79 FR 43627, July 28, 2014; T.D. 9745, 80 FR 78975, Dec. 18, 2015; 81 FR 2088, Jan. 15, 2016; T.D. 9804, 81 FR 91765, Dec. 19, 2016; T.D. 9822, 82 FR 34606, July 26, 2017]

§ 1.36B–4 Reconciling the premium tax credit with advance credit payments.

(a) *Reconciliation*—(1) *Coordination of premium tax credit with advance credit payments*—(i) *In general.* A taxpayer must reconcile the amount of credit allowed under section 36B with advance credit payments on the taxpayer's income tax return for a taxable year. A taxpayer whose premium tax credit for the taxable year exceeds the taxpayer's advance credit payments may receive the excess as an income tax refund. A taxpayer whose advance credit payments for the taxable year exceed the taxpayer's premium tax credit owes the excess as an additional income tax liability.

(ii) *Allocation rules and responsibility for advance credit payments*—(A) *In general.* A taxpayer must reconcile all advance credit payments for coverage of any member of the taxpayer's family.

(B) *Individuals enrolled by a taxpayer and claimed as a personal exemption deduction by another taxpayer*—(*1*) *In general.* If a taxpayer (the enrolling taxpayer) enrolls an individual in a qualified health plan and another taxpayer (the claiming taxpayer) claims a personal exemption deduction for the individual (the shifting enrollee), then for purposes of computing each taxpayer's premium tax credit and reconciling any advance credit payments, the enrollment premiums and advance credit payments for the plan in which the shifting enrollee was enrolled are allocated under this paragraph (a)(1)(ii)(B) according to the allocation percentage described in paragraph (a)(1)(ii)(B)(*2*) of this section. If advance credit payments are allocated under paragraph (a)(1)(ii)(B)(*4*) of this section, the claiming taxpayer and enrolling taxpayer must use this same allocation percentage to calculate their §1.36B–3(d)(1)(ii) adjusted monthly premiums for the applicable benchmark plan (benchmark plan premiums). This paragraph (a)(1)(ii)(B) does not apply to amounts allocated under §1.36B–3(h) (qualified health plan covering more than one family) or if the shifting enrollee or enrollees are the only individuals enrolled in the qualified health plan. For purposes of this paragraph (a)(1)(ii)(B)(*1*), a taxpayer who is expected at enrollment in a qualified health plan to be the taxpayer filing an income tax return for the year of coverage with respect to an individual enrolling in the plan has enrolled that individual.

(*2*) *Allocation percentage.* The enrolling taxpayer and claiming taxpayer may agree on any allocation percentage between zero and one hundred percent. If the enrolling taxpayer and claiming taxpayer do not agree on an allocation percentage, the percentage is equal to the number of shifting enrollees claimed as a personal exemption deduction by the claiming taxpayer divided by the number of individuals enrolled by the enrolling taxpayer in the same qualified health plan as the shifting enrollee.

(*3*) *Allocating premiums.* In computing the premium tax credit, the claiming taxpayer is allocated a portion of the enrollment premiums for the plan in which the shifting enrollee was enrolled equal to the enrollment premiums times the allocation percentage. The enrolling taxpayer is allocated the remainder of the enrollment premiums not allocated to one or more claiming taxpayers.

(*4*) *Allocating advance credit payments.* In reconciling any advance credit payments, the claiming taxpayer is allocated a portion of the advance credit payments for the plan in which the shifting enrollee was enrolled equal to the enrolling taxpayer's advance credit payments for the plan times the allocation percentage. The enrolling taxpayer is allocated the remainder of the advance credit payments not allocated to one or more claiming taxpayers. This paragraph (a)(1)(ii)(B)(*4*) only applies in situations in which advance credit payments are made for coverage of a shifting enrollee.

(*5*) *Premiums for the applicable benchmark plan.* If paragraph (a)(1)(ii)(B)(*4*) of this section applies, the claiming taxpayer's benchmark plan premium is the sum of the benchmark plan premium for the claiming taxpayer's coverage family, excluding the shifting enrollee or enrollees, and the allocable portion. The allocable portion for purposes of this paragraph (a)(1)(ii)(B)(*5*) is the product of the benchmark plan premium for the enrolling taxpayer's coverage family if the shifting enrollee was a member of the enrolling taxpayer's coverage family and the allocation percentage. If the enrolling taxpayer's coverage family is enrolled in more than one qualified health plan, the allocable portion is determined as if the enrolling taxpayer's coverage family includes only the coverage family members who enrolled in the same plan as the shifting enrollee or enrollees. The enrolling taxpayer's benchmark plan premium is the benchmark plan premium for the enrolling taxpayer's coverage family had the shifting enrollee or enrollees remained a part of the enrolling taxpayer's coverage family, minus the allocable portion.

(C) *Responsibility for advance credit payments for an individual for whom no personal exemption deduction is claimed.* If advance credit payments are made for coverage of an individual for whom no taxpayer claims a personal exemption deduction, the taxpayer who attested to the Exchange to the intention to claim a personal exemption deduction for the individual as part of the advance credit payment eligibility determination for coverage of the individual must reconcile the advance credit payments.

(iii) *Advance credit payment for a month in which an issuer does not provide coverage.* For purposes of reconciliation, a taxpayer does not have an advance credit payment for a month if the issuer of the qualified health plan in which the taxpayer or a family member is enrolled does not provide coverage for that month.

(2) *Credit computation.* The premium assistance credit amount is computed on the taxpayer's return using the taxpayer's household income and family size for the taxable year. Thus, the taxpayer's contribution amount (household income for the taxable year times the applicable percentage) is determined using the taxpayer's household income and family size at the end of the taxable year. The applicable benchmark plan for each coverage month is determined under § 1.36B–3(f).

(3) *Limitation on additional tax*—(i) *In general.* The additional tax imposed under paragraph (a)(1) of this section on a taxpayer whose household income is less than 400 percent of the Federal poverty line is limited to the amounts provided in the table in paragraph (a)(3)(ii) of this section (or successor tables). For taxable years beginning after December 31, 2014, the limitation amounts may be adjusted in published guidance, see § 601.601(d)(2) of this chapter, to reflect changes in the consumer price index.

(ii) *Additional tax limitation table.*

Household income percentage of Federal poverty line	Limitation amount for taxpayers whose tax is determined under section 1(c)	Limitation amount for all other taxpayers
Less than 200%	$300	$600
At least 200% but less than 300%	750	1,500
At least 300% but less than 400%	1,250	2,500

(iii) *Limitation on additional tax for taxpayers who claim a section 162(l) deduction for a qualified health plan*—(A) *In general.* A taxpayer who receives advance credit payments and deducts premiums for a qualified health plan under section 162(l) must use paragraph (a)(3)(iii)(B), and paragraph (a)(3)(iii)(C) or (D), of this section to determine the limitation on additional tax in this paragraph (a)(3) (limitation amount). Taxpayers must make this determination before calculating their section 162(l) deduction and premium tax credit. For additional rules for taxpayers who may claim a deduction under section 162(l) for a qualified health plan for which advance credit payments are made, see §1.162(l)–1.

(B) *Determining the limitation amount.* A taxpayer described in paragraph (a)(3)(iii)(A) of this section must use the limitation amount for which the taxpayer qualifies under paragraph (a)(3)(iii)(C) or (D) of this section. The limitation amount determined under this paragraph (a)(3)(iii) replaces the limitation amount that would otherwise be determined under the additional tax limitation table in paragraph (a)(3)(ii) of this section. In applying paragraph (a)(3)(iii)(C) of this section, a taxpayer must first determine whether he or she qualifies for the limitation amount applicable to taxpayers with household income of less than 200 percent of the Federal poverty line for the taxpayer's family size. If the taxpayer does not qualify to use the limitation amount applicable to taxpayers with household income of less than 200 percent of the Federal poverty line for the taxpayer's family size, the taxpayer must next determine whether he or she qualifies for the limitation applicable to taxpayers with household income of less than 300 percent of the Federal poverty line for the taxpayer's family size. If the taxpayer does not qualify to use the limitation amount applicable to taxpayers with household income of less than 300 percent of the Federal poverty line for the taxpayer's family size, the taxpayer must next determine whether he or she qualifies for the limitation applicable to taxpayers with household income of less than 400 percent of the Federal poverty line for the taxpayer's family size. If the taxpayer does not qualify to use the limitation amount applicable to taxpayers with household income of less than 200 percent, 300 percent, or 400 percent of the Federal poverty line for the taxpayer's family size, the limitation on additional tax under section 36B(f)(2)(B) does not apply to the taxpayer.

(C) *Requirements.* A taxpayer meets the requirements of this paragraph (a)(3)(iii)(C) for a limitation amount if the taxpayer's household income as a percentage of the Federal poverty line is less than or equal to the maximum household income as a percentage of the Federal poverty line for which that limitation is available. Household income for this purpose is determined by using a section 162(l) deduction equal to the lesser of—

(*1*) The sum of the specified premiums for the plan not paid through advance credit payments, the limitation amount (determined without regard to paragraph (a)(1)(iii)(C)(*2*) of this section), and any deduction allowable under section 162(l) for premiums other than specified premiums, and

(*2*) The earned income from the trade or business with respect to which the health insurance plan is established.

(D) *Specified premiums not paid through advance credit payments.* For purposes of paragraph (a)(3)(iii)(C) of this section, specified premiums not paid through advance credit payments means specified premiums, as defined in §1.162(l)–1(a)(2), minus advance credit payments made with respect to the specified premiums.

(E) *Examples.* For examples illustrating the rules of this paragraph (a)(3)(iii), see *Examples 13, 14,* and *15* of paragraph (a)(4) of this section.

(4) *Examples.* The following examples illustrate the rules of this paragraph (a). In each example the taxpayer enrolls in a higher cost qualified health plan than the applicable benchmark plan:

Example 1. Household income increases. (i) Taxpayer A is single and has no dependents. The Exchange for A's rating area projects A's 2014 household income to be $27,925 (250 percent of the Federal poverty line for a family of one, applicable percentage 8.05). A enrolls in a qualified health plan. The annual premium for the applicable benchmark plan is $5,200. A's advance credit payments are

$2,952, computed as follows: benchmark plan premium of $5,200 less contribution amount of $2,248 (projected household income of $27,925 × .0805) = $2,952.

(ii) A's household income for 2014 is $33,622, which is 301 percent of the Federal poverty line for a family of one (applicable percentage 9.5). Consequently, A's premium tax credit for 2014 is $2,006 (benchmark plan premium of $5,200 less contribution amount of $3,194 (household income of $33,622 × .095)). Because A's advance credit payments for 2014 are $2,952 and A's 2014 credit is $2,006, A has excess advance payments of $946. Under paragraph (a)(1) of this section, A's tax liability for 2014 is increased by $946. Because A's household income is between 300 percent and 400 percent of the Federal poverty line, if A's excess advance payments exceeded $1,250, under the limitation of paragraph (a)(3) of this section, A's additional tax liability would be limited to that amount.

Example 2. Household income increases, repayment limitation applies. The facts are the same as in *Example 1*, except that A's household income for 2014 is $43,560 (390 percent of the Federal poverty line for a family of one, applicable percentage 9.5). Consequently, A's premium tax credit for 2014 is $1,062 ($5,200 benchmark plan premium less contribution amount of $4,138 (household income of $43,560 × .095)). A's advance credit payments for 2014 are $2,952; therefore, A has excess advance payments of $1,890. Because A's household income is between 300 percent and 400 percent of the Federal poverty line, A's additional tax liability for the taxable year is $1,250 under the repayment limitation of paragraph (a)(3) of this section.

Example 3. Household income decreases. The facts are the same as in *Example 1*, except that A's actual household income for 2014 is $22,340 (200 percent of the Federal poverty line for a family of one, applicable percentage 6.3). Consequently, A's premium tax credit for 2014 is $3,793 ($5,200 benchmark plan premium less contribution amount of $1,407 (household income of $22,340 × .063)). Because A's advance credit payments for 2014 are $2,952, A is allowed an additional credit of $841 ($3,793 less $2,952).

Example 4. Family size decreases. (i) Taxpayers B and C are married and have two children, K and L (ages 17 and 20), whom they claim as dependents in 2013. The Exchange for their rating area projects their 2014 household income to be $63,388 (275 percent of the Federal poverty line for a family of four, applicable percentage 8.78). B and C enroll in a qualified health plan for 2014 that covers the four family members. The annual premium for the applicable benchmark plan is $14,100. B's and C's advance credit payments for 2014 are $8,535, computed as follows: Benchmark plan premium of $14,100 less contribution amount of $5,565 (projected household income of $63,388 × .0878) = $8,535.

(ii) In 2014, B and C do not claim L as their dependent (and no taxpayer claims a personal exemption deduction for L). Consequently, B's and C's family size for 2014 is three, their household income of $63,388 is 332 percent of the Federal poverty line for a family of three (applicable percentage 9.5), and the annual premium for their applicable benchmark plan is $12,000. Their premium tax credit for 2014 is $5,978 ($12,000 benchmark plan premium less $6,022 contribution amount (household income of $63,388 × .095)). Because B's and C's advance credit payments for 2014 are $8,535 and their 2014 credit is $5,978, B and C have excess advance payments of $2,557. B's and C's additional tax liability for 2014 under paragraph (a)(1) of this section, however, is limited to $2,500 under paragraph (a)(3) of this section.

Example 5. Repayment limitation does not apply. (i) Taxpayer D is single and has no dependents. The Exchange for D's rating area approves advance credit payments for D based on 2014 household income of $39,095 (350 percent of the Federal poverty line for a family of one, applicable percentage 9.5). D enrolls in a qualified health plan. The annual premium for the applicable benchmark plan is $5,200. D's advance credit payments are $1,486, computed as follows: benchmark plan premium of $5,200 less contribution amount of $3,714 (projected household income of $39,095 × .095) = $1,486.

(ii) D's actual household income for 2014 is $44,903, which is 402 percent of the Federal poverty line for a family of one. D is not an applicable taxpayer and may not claim a premium tax credit. Additionally, the repayment limitation of paragraph (a)(3) of this section does not apply. Consequently, D has excess advance payments of $1,486 (the total amount of the advance credit payments in 2014). Under paragraph (a)(1) of this section, D's tax liability for 2014 is increased by $1,486.

Example 6. Coverage for less than a full taxable year. (i) Taxpayer F is single and has no dependents. In November 2013, the Exchange for F's rating area projects F's 2014 household income to be $27,925 (250 percent of the Federal poverty line for a family of one, applicable percentage 8.05). F enrolls in a qualified health plan. The annual premium for the applicable benchmark plan is $5,200. F's monthly advance credit payment is $246, computed as follows: benchmark plan premium of $5,200 less contribution amount of $2,248 (projected household income of $27,925 × .0805) = $2,952; $2,952/12 = $246.

(ii) F begins a new job in August 2014 and is eligible for employer-sponsored minimum essential coverage for the period September through December 2014. F discontinues her Exchange coverage effective November 1, 2014. F's household income for 2014 is $28,707 (257 percent of the Federal poverty line for a family size of one, applicable percentage 8.25).

(iii) Under §1.36B–3(a), F's premium assistance credit amount is the sum of the premium assistance amounts for the coverage months. Under §1.36B–3(c)(1)(iii), a month in which an individual is eligible for minimum essential coverage other than coverage in the individual market is not a coverage month. Because F is eligible for employer-sponsored minimum essential coverage as of September 1, only the months January through August of 2014 are coverage months.

(iv) If F had 12 coverage months in 2014, F's premium tax credit would be $2,832 (benchmark plan premium of $5,200 less contribution amount of $2,368 (household income of $28,707 × .0825)). Because F has only eight coverage months in 2014, F's credit is $1,888 ($2,832/12 × 8). Because F does not discontinue her Exchange coverage until November 1, 2014, F's advance credit payments for 2014 are $2,460 ($246 × 10). Consequently, F has excess advance payments of $572 ($2,460 less $1,888) and F's tax liability for 2014 is increased by $572 under paragraph (a)(1) of this section.

Example 7. Changes in coverage months and applicable benchmark plan. (i) Taxpayer E claims one dependent, F. E is eligible for government-sponsored minimum essential coverage. E enrolls F in a qualified health plan for 2014. The Exchange for E's rating area projects E's 2014 household income to be $30,260 (200 percent of the Federal poverty line for a family of two, applicable percentage 6.3). The annual premium for E's applicable benchmark plan is $5,200. E's monthly advance credit payment is $275, computed as follows: benchmark plan premium of $5,200 less contribution amount of $1,906 (projected household income of $30,260 × .063) = $3,294; $3,294/12 = $275.

(ii) On August 1, 2014, E loses her eligibility for government-sponsored minimum essential coverage. E enrolls in the qualified health plan that covers F for August through December 2014. The annual premium for the applicable benchmark plan is $10,000. The Exchange computes E's monthly advance credit payments for the period September through December to be $675 as follows: benchmark plan premium of $10,000 less contribution amount of $1,906 (projected household income of $30,260 × .063) = $8,094; $8,094/12 = $675. E's household income for 2014 is $28,747 (190 percent of the Federal poverty line, applicable percentage 5.84).

(iii) Under §1.36B–3(c)(1), January through July of 2014 are coverage months for F and August through December are coverage months for E and F. Under paragraph (a)(2) of this section, E must compute her premium tax credit using the premium for the applicable benchmark plan for each coverage month. E's premium assistance credit amount for 2014 is the sum of the premium assistance amounts for all coverage months. E reconciles her premium tax credit with advance credit payments as follows:

Advance credit payments (Jan. to July)	$1,925	($275 × 7)
Advance credit payments (Aug. to Dec.)	3,375	($675 × 5)
Total advance credit payments	5,300	
Benchmark plan premium (Jan. to July)	3,033	(($5,200/12) × 7)
Benchmark plan premium (Aug. to Dec.)	4,167	(($10,000/12) × 5)
Total benchmark plan premium	7,200	
Contribution amount (taxable year household income × applicable percentage).	1,679	($28,747 × .0584)
Credit (total benchmark plan premium less contribution amount).	5,521	

(iv) E's advance credit payments for 2014 are $5,300. E's premium tax credit is $5,521. Thus, E is allowed an additional credit of $221.

Example 8. Part-year coverage and changes in coverage months and applicable benchmark plan. (i) The facts are the same as in *Example 7*, except that F is eligible for government-sponsored minimum essential coverage for January and February 2014, and E enrolls F in a qualified health plan beginning in March 2014. Thus, March through July are coverage months for F and August through December are coverage months for E and F.

(ii) E reconciles her premium tax credit with advance credit payments as follows:

Advance credit payments (March to July)	$1,375	($275 × 5)
Advance credit payments (Aug. to Dec.)	3,375	($675 × 5)
Total advance credit payments	4,750	
Benchmark plan premium (March to July)	2,167	(($5,200/12) × 5)

Benchmark plan premium (Aug. to Dec.)	4,167	(($10,000/12) × 5)
Total benchmark plan premium	6,334	
Contribution amount for 10 coverage months (taxable year household income × applicable percentage × 10/12).	1,399	($28,747 × .0584 × 10/12)
Credit (total benchmark plan premium less contribution amount).	4,935	

(iii) E's advance credit payments for 2014 are $4,750. E's premium tax credit is $4,935. Thus, E is allowed an additional credit of $185.

Example 9. Advance credit payments for months an issuer does not provide coverage. (i) Taxpayer F enrolls in a qualified health plan for 2014 and the Exchange approves advance credit payments. F pays the portion of the premium not covered by advance credit payments for January through April of 2014 but fails to make payments in May, June, and July. As a result, the issuer of the qualified health plan initiates the 3-month grace period under section 1412(c)(2)(B)(iv)(II) of the Affordable Care Act and 45 CFR 156.270(d). During the grace period the issuer continues to receive advance credit payments on behalf of F. On July 1 the issuer rescinds F's coverage retroactive to the end of the first month of the grace period, May 31.

(ii) Under paragraph (a)(1)(iii) of this section, F does not take into account advance credit payments for June or July of 2014 when reconciling the premium tax credit with advance credit payments under paragraph (a)(1) of this section.

Example 10. Allocation percentage, agreement on allocation. (i) Taxpayers G and H are divorced and have two children, J and K. G enrolls herself and J and K in a qualified health plan for 2014. The premium for the plan in which G enrolls is $13,000. The Exchange in G's rating area approves advance credit payments for G based on a family size of three, an annual benchmark plan premium of $12,000, and projected 2014 household income of $58,590 (300 percent of the Federal poverty line for a family of three, applicable percentage 9.5). G's advance credit payments for 2014 are $6,434 ($12,000 benchmark plan premium less $5,566 contribution amount (household income of $58,590 × .095)). G's actual household income for 2014 is $58,900.

(ii) K lives with H for more than half of 2014 and H claims K as a dependent for 2014. G and H agree to an allocation percentage, as described in paragraph (a)(1)(ii)(B)(*2*) of this section, of 20 percent. Under the agreement, H is allocated 20 percent of the items to be allocated, and G is allocated the remainder of those items.

(iii) If H is eligible for a premium tax credit, H takes into account $2,600 of the premiums for the plan in which K was enrolled ($13,000 x .20) and $2,400 of G's benchmark plan premium ($12,000 × .20). In addition, H is responsible for reconciling $1,287 ($6,434 × .20) of the advance credit payments for K's coverage.

(iv) G's family size for 2014 includes only G and J and G's household income of $58,900 is 380 percent of the Federal poverty line for a family of two (applicable percentage 9.5). G's benchmark plan premium for 2014 is $9,600 (the benchmark premium for the plan covering G, J, and K ($12,000), minus the amount allocated to H ($2,400). Consequently, G's premium tax credit is $4,004 (G's benchmark plan premium of $9,600 minus G's contribution amount of $5,596 ($58,900 × .095)). G has an excess advance payment of $1,143 (the excess of the advance credit payments of $5,147 ($6,434 − $1,287 allocated to H) over the premium tax credit of $4,004).

Example 11. Allocation percentage, no agreement on allocation. (i) The facts are the same as in *Example 10* of paragraph (a)(4) of this section, except that G and H do not agree on an allocation percentage. Under paragraph (a)(1)(ii)(B)(*2*) of this section, the allocation percentage is 33 percent, computed as follows: The number of shifting enrollees, 1 (K), divided by the number of individuals enrolled by the enrolling taxpayer on the same qualified health plan as the shifting enrollee, 3 (G, J, and K). Thus, H is allocated 33 percent of the items to be allocated, and G is allocated the remainder of those items.

(ii) If H is eligible for a premium tax credit, H takes into account $4,290 of the premiums for the plan in which K was enrolled ($13,000 × .33). H, in computing H's benchmark plan premium, must include $3,960 of G's benchmark plan premium ($12,000 x .33). In addition, H is responsible for reconciling $2,123 ($6,434 x .33) of the advance credit payments for K's coverage.

(iii) G's benchmark plan premium for 2014 is $8,040 (the benchmark premium for the plan covering G, J, and K ($12,000), minus the amount allocated to H ($3,960). Consequently, G's premium tax credit is $2,444 (G's benchmark plan premium of $8,040 minus G's contribution amount of $5,596 ($58,900 × .095)). G has an excess advance credit payment of $1,867 (the excess of the advance credit payments of $4,311 ($6,434 − $2,123 allocated to H) over the premium tax credit of $2,444).

Example 12. Allocations for an emancipated child. Spouses L and M enroll in a qualified health plan with their child, N. L and M attest that they will claim N as a dependent and advance credit payments are made for the coverage of all three family members. However, N files his own return and claims a personal exemption deduction for himself for the taxable year. Under paragraph (a)(1)(ii)(B)(*1*) of this section, L and M are enrolling taxpayers, N is a claiming taxpayer, and all are subject to the allocation rules in paragraph (a)(1)(ii)(B) of this section.

Example 13. Taxpayer with advance credit payments allowed a section 162(l) deduction but not a limitation on additional tax. (i) In 2014, B, B's spouse, and their two dependents enroll in the applicable second lowest cost silver plan with an annual premium of $14,000. B's advance credit payments attributable to the premiums are $8,000. B is self-employed for all of 2014 and derives $75,000 of earnings from B's trade or business. B's household income without including a deduction under section 162(l) for specified premiums is $103,700. The Federal poverty line for a family the size of B's family is $23,550.

(ii) Because B received the benefit of advance credit payments and deducts premiums for a qualified health plan under section 162(l), B must determine whether B is allowed a limitation on additional tax under paragraph (a)(3)(iii) of this section. B begins by testing eligibility for the $600 limitation amount for taxpayers with household income at less than 200 percent of the Federal poverty line for the taxpayer's family size. B determines household income as a percentage of the Federal poverty line by taking a section 162(l) deduction equal to the lesser of $6,600 (the sum of the amount of premiums not paid through advance credit payments, $6,000 ($14,000 − $8,000), and the limitation amount, $600) and $75,000 (the earned income from the trade or business with respect to which the health insurance plan is established). The result is $97,100 ($103,700 − $6,600) or 412 percent of the Federal poverty line for B's family size. Since 412 percent is not less than 200 percent, B may not use a $600 limitation amount.

(iii) B performs the same calculation for the $1,500 ($103,700 − $7,500 = $96,200 or 408 percent of the Federal poverty line) and $2,500 limitation amounts ($103,700 − $8,500 = $95,200 or 404 percent of the Federal poverty line), the amounts for taxpayers with household income of less than 300 percent or 400 percent, respectively, of the Federal poverty line for the taxpayer's family size, and determines that B may not use either of those limitation amounts. Because B does not meet the requirements of paragraph (a)(3)(iii) of this section for any of the limitation amounts in section 36B(f)(2)(B), B is not eligible for the limitation on additional tax for excess advance credit payments.

(iv) Although B may not claim a limitation on additional tax for excess advance credit payments, B may still be eligible for a premium tax credit. B would determine eligibility for the premium tax credit, the amount of the premium tax credit, and the section 162(l) deduction using the rules under section 36B and section 162(l), applying no limitation on additional tax.

Example 14. Taxpayer with advance credit payments allowed a section 162(l) deduction and a limitation on additional tax. (i) The facts are the same as in *Example 13* of paragraph (a)(4) of this section, except that B's household income without including a deduction under section 162(l) for specified premiums is $78,802.

(ii) Because B received the benefit of advance credit payments and deducts premiums for a qualified health plan under section 162(l), B must determine whether B is allowed a limitation on additional tax under paragraph (a)(3)(iii) of this section. B first determines that B does not meet the requirements of paragraph (a)(3)(iii)(C) of this section for using the $600 or $1,500 limitation amounts, the amounts for taxpayers with household income of less than 200 percent or 300 percent, respectively, of the Federal poverty line for the taxpayer's family size. That is because B's household income as a percentage of the Federal poverty line, determined by using a section 162(l) deduction for premiums for the qualified health plan equal to the lesser of the sum of the premiums for the plan not paid through advance credit payments and the limitation amount, and the earned income from the trade or business with respect to which the health insurance plan is established, is more than the maximum household income as a percentage of the Federal poverty line for which that limitation is available (using the $600 limitation, B's household income would be $72,202 ($78,802 − ($6,000 + $600)), which is 307 percent of the Federal poverty line for B's family size; and using the $1,500 limitation, B's household income would be $71,302 ($78,802 − ($6,000 + $1,500)), which is 303 percent of the Federal poverty line for B's family size).

(iii) However, B meets the requirements of paragraph (a)(3)(iii)(C) of this section using the $2,500 limitation amount for taxpayers with household income of less than 400 percent of the Federal poverty line for the taxpayer's family size. That is because B's household income as a percentage of the Federal poverty line by taking a section 162(l) deduction equal to the lesser of $8,500 (the sum of the amount of premiums not paid through advance credit payments, $6,000, and the limitation amount, $2,500) and $75,000 (the earned income from the trade or business with respect to which the health insurance plan is established), is $70,302 (299 percent of the Federal poverty line), which is below 400 percent of the Federal poverty line for B's family size, and is less than the maximum amount for which that limitation is available. Thus, B uses a limitation amount of $2,500 in computing B's additional tax on excess advance credit payments.

(iv) B may determine the amount of the premium tax credit and the section 162(l) deduction using the rules under section 36B and section 162(l), applying the $2,500 limitation amount determined above.

Example 15. Taxpayer with advance credit payments allowed a section 162(l) deduction and a limitation on additional tax limited to earned income from trade or business. (i) In 2017, C, C's spouse, and their two dependents enroll in the applicable second lowest cost silver plan with an annual premium of $14,000. C's advance credit payments attributable to the premiums are $8,000. C is self-employed for all of 2017 and derives $3,000 of earnings from C's trade or business. C's household income, without including a deduction under section 162(l) for specified premiums, is $39,100. The Federal poverty line for a family the size of C's family is $24,600.

(ii) Because C received the benefit of advance credit payments and deducts premiums for a qualified health plan under section 162(l), C must determine whether C is allowed a limitation on additional tax under paragraph (a)(3)(iii) of this section. C begins by testing eligibility for the $600 limitation amount for taxpayers with household income at less than 200 percent of the Federal poverty line for the taxpayer's family size. C determines household income as a percentage of the Federal poverty line by taking a section 162(l) deduction equal to the lesser of $6,600 (the sum of the amount of premiums not paid through advance credit payments, $6,000 ($14,000 − $8,000), and the limitation amount, $600), and $3,000 (C's earned income from the trade or business with respect to which the health insurance plan is established). The result is $36,100 ($39,100 − $3,000) or 147 percent of the Federal poverty line for C's family size. Because 147 percent is less than 200 percent, the limitation amount under paragraph (a)(3)(iii) of this section that C uses in computing C's additional tax on excess advance credit payments is $600.

(iii) C may determine the amount of the premium tax credit and the section 162(l) deduction using the rules under section 36B and section 162(l), applying the $600 limitation amount determined above.

(b) *Changes in filing status*—(1) *In general.* Except as provided in paragraph (b)(2) or (b)(3) of this section, a taxpayer whose marital status changes during the taxable year computes the premium tax credit by using the applicable benchmark plan or plans for the taxpayer's marital status as of the first day of each coverage month. The taxpayer's contribution amount (household income for the taxable year times the applicable percentage) is determined using the taxpayer's household income and family size at the end of the taxable year.

(2) *Taxpayers who marry during the taxable year*—(i) *In general.* Taxpayers who marry during and file a joint return for the taxable year may compute the additional tax imposed under paragraph (a)(1) of this section under paragraph (b)(2)(ii) of this section. Only taxpayers who are unmarried at the beginning of the taxable year and are married (within the meaning of section 7703) at the end of the taxable year, at least one of whom receives advance credit payments, may use this alternative computation.

(ii) *Alternative computation of additional tax liability*—(A) *In general.* The additional tax liability determined under this paragraph (b)(2)(ii) is equal to the excess of the taxpayers' advance credit payments for the taxable year over the amount of the alternative marriage-year credit. The alternative marriage-year credit is the sum of both taxpayers' alternative premium assistance amounts for the pre-marriage months and the premium assistance amounts for the marriage months. This paragraph (b)(2)(ii) may not be used to increase the additional premium tax credit computed under paragraph (a)(1)(i) of this section.

(B) *Alternative premium assistance amounts for pre-marriage months.* Taxpayers compute the alternative premium assistance amounts for each taxpayer for each full or partial month the taxpayers are unmarried as described in paragraph (a)(2) of this section, except that each taxpayer treats the amount of household income as one-half of the actual household income for the taxable year and treats family size as the number of individuals in the taxpayer's family prior to the marriage. The taxpayers may include a dependent of the taxpayers for the taxable year in either taxpayer's family size for the pre-marriage months.

(C) *Premium assistance amounts for marriage months.* Taxpayers compute the premium assistance amounts for each full month the taxpayers are married as described in paragraph (a)(2) of this section.

(3) *Taxpayers not married to each other at the end of the taxable year*. Taxpayers who are married (within the meaning of section 7703) to each other during a taxable year but legally separate under a decree of divorce or of separate maintenance during the taxable year, and who are enrolled in the same qualified health plan at any time during the taxable year must allocate the benchmark plan premiums, the enrollment premiums, and the advance credit payments for the period the taxpayers are married during the taxable year. Taxpayers must also allocate these items if one of the taxpayers has a dependent enrolled in the same plan as the taxpayer's former spouse or enrolled in the same plan as a dependent of the taxpayer's former spouse. The taxpayers may allocate these items to each former spouse in any proportion but must allocate all items in the same proportion. If the taxpayers do not agree on an allocation that is reported to the IRS in accordance with the relevant forms and instructions, 50 percent of: The benchmark plan premiums; the enrollment premiums; and the advance credit payments for the married period, is allocated to each taxpayer. If for a period a plan covers only one of the taxpayers and no dependents, only one of the taxpayers and one or more dependents of that same taxpayer, or only one or more dependents of one of the taxpayers, then the benchmark plan premiums, the enrollment premiums, and the advance credit payments for that period are allocated entirely to that taxpayer.

(4) *Taxpayers filing returns as married filing separately or head of household*—(i) *Allocation of advance credit payments*. Except as provided in §1.36B–2(b)(2)(ii), the premium tax credit is allowed to married (within the meaning of section 7703) taxpayers only if they file joint returns. *See* §1.36B–2(b)(2)(i). Taxpayers who receive advance credit payments as married taxpayers and who do not file a joint return must allocate the advance credit payments for coverage under a qualified health plan equally to each taxpayer for any period the plan covers and in which advance credit payments are made for both taxpayers, only one of the taxpayers and one or more dependents of the other taxpayer, or one or more dependents of both taxpayers. If, for a period a plan covers, advance credit payments are made for only one of the taxpayers and no dependents, only one of the taxpayers and one or more dependents of that same taxpayer, or only one or more dependents of one of the taxpayers, the advance credit payments for that period are allocated entirely to that taxpayer. If one or both of the taxpayers is an applicable taxpayer eligible for a premium tax credit for the taxable year, the premium tax credit is computed by allocating the enrollment premiums under paragraph (b)(4)(ii) of this section. The repayment limitation described in paragraph (a)(3) of this section applies to each taxpayer based on the household income and family size reported on that taxpayer's return. This paragraph (b)(4) also applies to taxpayers who receive advance credit payments as married taxpayers and file a tax return using the head of household filing status.

(ii) *Allocation of premiums*. If taxpayers who are married within the meaning of section 7703, without regard to section 7703(b), do not file a joint return, 50 percent of the enrollment premiums are allocated to each taxpayer. However, all of the enrollment premiums are allocated to only one of the taxpayers for a period in which a qualified health plan covers only that taxpayer and no dependents, only that taxpayer and one or more dependents of that taxpayer, or only one or more dependents of that taxpayer.

(5) *Examples*. The following examples illustrate the provisions of this paragraph (b). In each example the taxpayer enrolls in a higher cost qualified health plan than the applicable benchmark plan:

Example 1. Taxpayers marry during the taxable year, general rule for computing additional tax. (i) P is a single taxpayer with no dependents. In 2013 the Exchange for the rating area where P resides determines that P's 2014 household income will be $40,000 (358 percent of the Federal poverty line, applicable percentage 9.5). P enrolls in a qualified health plan. The premium for the applicable benchmark plan is $5,200. P's monthly advance credit payment is $117, computed as follows:

$5,200 benchmark plan premium minus contribution amount of $3,800 ($40,000 × .095) equals $1,400 (total advance credit payment); $1,400/12 = $117.

(ii) Q is a single taxpayer with two dependents. In 2013 the Exchange for the rating area where Q resides determines that Q's 2014 household income will be $35,000 (183 percent of the Federal poverty line, applicable percentage 5.52). Q enrolls in a qualified health plan. The premium for the applicable benchmark plan is $10,000. Q's monthly advance credit payment is $672, computed as follows: $10,000 benchmark plan premium minus contribution amount of $1,932 ($35,000 × .0552) equals $8,068 (total advance credit); $8,068/12 = $672.

(iii) P and Q marry on July 17, 2014 and enroll in a single policy for a qualified health plan covering four family members, effective August 1, 2014. The premium for the applicable benchmark plan is $14,000. Based on household income of $75,000 and a family size of four (325 percent of the Federal poverty line, applicable percentage 9.5), the Exchange approves advance credit payments of $573 per month, computed as follows: $14,000 benchmark plan premium minus contribution amount of $7,125 ($75,000 × .095) equals $6,875 (total advance credit); $6,875/12 = $573.

(iv) P and Q file a joint return for 2014 and report $75,000 in household income and a family size of four. P and Q compute their credit at reconciliation under paragraph (b)(1) of this section. They use the premiums for the applicable benchmark plans that apply for the months married and the months not married, and their contribution amount is based on their Federal poverty line percentage at the end of the taxable year. P and Q reconcile their premium tax credit with advance credit payments as follows:

Advance payments for P (Jan. to July)	$819
Advance payments for Q (Jan. to July)	4,704
Advance payments for P and Q (Aug. to Dec.)	2,865
Total advance payments	8,388
Benchmark plan premium for P (Jan. to July)	3,033
Benchmark plan premium for Q (Jan. to July)	5,833
Benchmark plan premium for P and Q (Aug. to Dec.)	5,833
Total benchmark plan premium	14,699
Contribution amount (taxable year household income × applicable percentage)	7,125
Credit (total benchmark plan premium less contribution amount)	7,574
Additional tax	814

(v) P's and Q's tax liability for 2014 is increased by $814 under paragraph (a)(1) of this section.

Example 2. Taxpayers marry during the taxable year, alternative computation of additional tax. (i) The facts are the same as in *Example 1*, except that P and Q compute their additional tax liability under paragraph (b)(2)(ii) of this section. P's and Q's additional tax is the excess of their advance credit payments for the taxable year ($8,388) over their alternative marriage-year credit, which is the sum of the alternative premium assistance amounts for the pre-marriage months and the premium assistance amounts for the marriage months.

(ii) P and Q compute the alternative marriage-year credit as follows:

Alternative premium assistance amounts for pre-marriage months:		
Benchmark plan premium for P (Jan. to July).	$3,033	(($5,200/12) × 7)
Contribution amount (½ taxable year household income × applicable percentage) × 7/12).	2,078	($37,500 × .095 × 7/12)
Alternative premium assistance amount for P's pre-marriage months.	955	($3,033 − $2,078)
Benchmark plan premium for Q (Jan. to July).	5,833	(($10,000/12) × 7)
Contribution amount (½ taxable year household income × applicable percentage × 7/12).	1,339	($37,500 × .0612 × 7/12)

Alternative premium assistance amount for Q's pre-marriage months.	4,494	($5,833 − $1,339)
Premium assistance amount for marriage months:		
Benchmark plan premium for P and Q (Aug. to Dec.).	5,833	(($14,000/12 × 5)
Contribution amount (taxable year household income × applicable percentage × 5/12).	2,969	($75,000 × .095 × 5/12)
Premium assistance amount for marriage months.	2,864	($5,833 − $2,969)

Alternative marriage-year credit (sum of premium assistance amounts for pre-marriage months and marriage months): $955 + $4,494 + $2,864 = $8,313.

(iii) P and Q reconcile their premium tax credit with advance credit payments by determining the excess of their advance credit payments ($8,388) over their alternative marriage-year credit ($8,313). P and Q must increase their tax liability by $75 under paragraph (a)(1) of this section.

Example 3. Taxpayers marry during the taxable year, alternative computation of additional tax, alternative marriage-year tax credit exceeds advance credit payments. The facts are the same as in *Example 2,* except that the amount of P's and Q's advance credit payments is $8,301. Thus, their alternative marriage-year credit ($8,313) exceeds the amount of their advance credit payments ($8,301). Under paragraph (b)(2)(ii)(A) of this section, the amount of additional tax liability and additional tax credit that P and Q report on their tax return is $0.

Example 4. Taxpayers marry during the taxable year, alternative computation of additional tax. (i) Taxpayer R is single and has no dependents. In 2013, the Exchange for the rating area where R resides determines that R's 2014 household income will be $40,000 (358 percent of the Federal poverty line, applicable percentage 9.5). R enrolls in a qualified health plan. The premium for the applicable benchmark plan is $5,200. R's monthly advance credit payment is $117, computed as follows: $5,200 benchmark plan premium minus contribution amount of $3,800 ($40,000 × .095) = $1,400 (total advance credit); $1,400/12 = $117.

(ii) Taxpayer S is single with no dependents. In 2013, the Exchange for the rating area where S resides determines that S's 2014 household income will be $20,000 (179 percent of the Federal poverty line, applicable percentage 5.33). S enrolls in a qualified health plan. The premium for the applicable benchmark plan is $5,200. S's monthly advance credit payment is $345, computed as follows: $5,200 benchmark plan premium minus contribution amount of $1,066 ($20,000 × .0533) = $4,134 (total advance credit); $4,134/12 = $345.

(iii) R and S marry in September 2014 and enroll in a single policy for a qualified health plan covering them both, beginning October 1, 2014. The premium for the applicable benchmark plan is $10,000. Based on household income of $60,000 and a family size of two (397 percent of the Federal poverty line, applicable percentage 9.5), R's and S's monthly advance credit payment is $358, computed as follows: $10,000 benchmark plan premium minus contribution amount of $5,700 ($60,000 × .095) = $4,300; $4,300/12 = $358. R's and S's advance credit payments for 2014 are $5,232, computed as follows:

Advance payments for R (Jan. to Sept.)	$1,053	($117 × 9)
Advance payments for S (Jan. to Sept.)	3,105	($345 × 9)
Advance payments for R and S (Oct. to Dec.)	1,074	($358 × 3)
Total advance payments	5,232	

(iv) R and S file a joint return for 2014 and report $62,000 in household income and a family size of two (410 percent of the FPL for a family of 2). Thus, under §1.36B–2(b)(2), R and S are not applicable taxpayers for 2014 and may not claim a premium tax credit for 2014. However, they compute their additional tax liability under paragraph (b)(2)(ii) of this section. R's and S's additional tax is the excess of their advance credit payments for the taxable year ($5,232) over their alternative marriage-year credit, which is the sum of the alternative premium assistance amounts for the pre-marriage months and the premium assistance amounts for the marriage months. In this case, R and S have no premium assistance amounts for the married months because their household income is over 400 percent of the Federal poverty line for a family of 2.

(v) R and S compute their alternative marriage-year credit as follows:

Premium assistance amount for pre-marriage months:		
Benchmark plan premium for R (Jan. to Sept.).	$3,900	(($5,200/12) × 9)
Contribution amount ((½ taxable year household income × applicable percentage) × 9/12).	2,053	($31,000 × .0883 × 9/12)
Premium assistance amount for R's pre-marriage months.	1,847	($3,900 − $2,053)
Benchmark plan premium for S (Jan. to Sept.).	3,900	(($5,200/12) × 9)
Contribution amount ((½ taxable year household income × applicable percentage) × 9/12).	2,053	($31,000 × .0883 × 9/12)
Premium assistance amount for S's pre-marriage months.	1,847	($3,900 − $2,053)
Premium assistance amount for marriage months	0	

Alternative marriage-year credit (sum of premium assistance amounts for pre-marriage months and marriage months): $1,847 + 1,847 + 0 = $3,694.

(vi) R and S reconcile their premium tax credit with advance credit payments by determining the excess of their advance credit payments ($5,232) over their alternative marriage-year credit ($3,694). R and S must increase their tax liability by $1,538 under paragraph (a)(1) of this section.

Example 5. (i) *Taxpayers marry during the taxable year, no additional tax liability.* The facts are the same as in *Example 4*, except that S has no income and is enrolled in Medicaid for January through September 2014 and R's and S's household income for 2014 is $37,000 (245 percent of the Federal poverty line, applicable percentage 7.88). Their advance credit payments for 2014 are $2,707 ($1,053 for R for January to September and $1,654 for R and S for October to December). Their premium tax credit for 2014 is $3,484 (total benchmark premium of $6,400 less contribution amount of $2,916).

(ii) Because R's and S's premium tax credit of $3,484 exceeds their advance credit payments of $2,707, R and S are allowed an additional credit of $777. Although R and S marry in 2014, paragraph (b)(2) of this section (the alternative computation of additional tax for taxpayers who marry during the taxable year) does not apply because they do not owe additional tax for 2014.

Example 6. Taxpayers divorce during the taxable year, 50 percent allocation. (i) Taxpayers V and W are married and have two dependents. In 2013, the Exchange for the rating area where the family resides determines that their 2014 household income will be $76,000 (330 percent of the Federal poverty line for a family of 4, applicable percentage 9.5). V and W enroll in a qualified health plan for 2014. The premium for the applicable benchmark plan is $14,100. The Exchange approves advance credit payments of $573 per month, computed as follows: $14,100 benchmark plan premium minus V and W's contribution amount of $7,220 ($76,000 × .095) equals $6,880 (total advance credit); $6,880/12 = $573.

(ii) V and W divorce on June 17, 2014, and obtain separate qualified health plans beginning July 1, 2014. V enrolls based on household income of $60,000 and a family size of three (314 percent of the Federal poverty line, applicable percentage 9.5). The premium for the applicable benchmark plan is $10,000. The Exchange approves advance credit payments of $358 per month, computed as follows: $10,000 benchmark plan premium minus V's contribution amount of $5,700 ($60,000 × .095) equals $4,300 (total advance credit); $4,300/12 = $358.

(iii) W enrolls based on household income of $16,420 and a family size of one (147 percent of the Federal poverty line, applicable percentage 3.82). The premium for the applicable benchmark plan is $5,200. The Exchange approves advance credit payments of $381 per month, computed as follows: $5,200 benchmark plan premium minus W's contribution amount of $627 ($16,420 × .0382) equals $4,573 (total advance credit); $4,573/12 = $381. V and W do not agree on an allocation of the premium for the applicable benchmark plan, the premiums for the plan in which they enroll, and the advance credit payments for the period they were married in the taxable year.

(iv) V and W each compute their credit at reconciliation under paragraph (b)(1) of this section, using the premiums for the applicable benchmark plans that apply to them for the months married and the months not married, and the contribution amount based on their Federal poverty line percentages at the end of the taxable year. Under paragraph (b)(3) of this section, because V and W do not agree on an allocation, V and W must equally allocate the benchmark plan premium ($7,050) and the advance credit payments ($3,438) for the six-month period January through June 2014 when they are married and enrolled in the same qualified health plan. Thus, V and W each are allocated $3,525 of the benchmark plan premium ($7,050/2) and

$1,719 of the advance credit payments ($3,438/2) for January through June.

(v) V reports on his 2014 tax return $60,000 in household income and family size of three. W reports on her 2014 tax return $16,420 in household income and family size of one. V and W reconcile their premium tax credit with advance credit payments as follows:

	V	W
Allocated advance payments (Jan. to June)	$1,719	$1,719
Actual advance payments (July to Dec.)	2,148	2,286
Total advance payments	3,867	4,005
Allocated benchmark plan premium (Jan. to June)	3,525	3,525
Actual benchmark plan premium (July to Dec.)	5,000	2,600
Total benchmark plan premium	8,525	6,125
Contribution amount (taxable year household income × applicable percentage)	5,700	627
Credit (total benchmark plan premium less contribution amount)	2,825	5,498
Additional credit	....	1,493
Additional tax	1,042	....

(vi) Under paragraph (a)(1) of this section, on their tax returns V's tax liability is increased by $1,042 and W is allowed $1,493 as additional credit.

Example 7. Taxpayers divorce during the taxable year, allocation in proportion to household income. (i) The facts are the same as in *Example 6*, except that V and W decide to allocate the benchmark plan premium ($7,050) and the advance credit payments ($3,438) for January through June 2014 in proportion to their household incomes (79 percent and 21 percent). Thus, V is allocated $5,570 of the benchmark plan premiums ($7,050 × .79) and $2,716 of the advance credit payments ($3,438 × .79), and W is allocated $1,481 of the benchmark plan premiums ($7,050 × .21) and $722 of the advance credit payments ($3,438 × .21). V and W reconcile their premium tax credit with advance credit payments as follows:

	V	W
Allocated advance payments (Jan. to June)	$2,716	$722
Actual advance payments (July to Dec.)	2,148	2,286
Total advance payments	4,864	3,008
Allocated benchmark plan premium (Jan. to June)	5,570	1,481
Actual benchmark plan premium (July to Dec.)	5,000	2,600
Total benchmark plan premium	10,570	4,081
Contribution amount (taxable year household income × applicable percentage)	5,700	627
Credit (total benchmark plan premium less contribution amount)	4,870	3,454
Additional credit	6	446

(ii) Under paragraph (a)(1) of this section, on their tax returns V is allowed an additional credit of $6 and W is allowed an additional credit of $446.

Example 8. Married taxpayers filing separate tax returns. (i) Taxpayers X and Y are married and have two dependents. In 2013, the Exchange for the rating area where the family resides determines that their 2014 household income will be $76,000 (330 percent of the Federal poverty line for a family of 4, applicable percentage 9.5). W and Y enroll in a qualified health plan for 2014. The premium for the applicable benchmark plan is $14,100. X's and Y's monthly advance credit payment is $573, computed as follows: $14,100 benchmark plan premium minus X's and Y's contribution amount of $7,220 ($76,000 × .095) equals $6,880 (total advance credit); $6,880/12 = $573.

(ii) X and Y file income tax returns for 2014 using a married filing separately filing status. X reports household income of $60,000 and a family size of three (314 percent of the Federal poverty line). Y reports household income of $16,420 and a family size of one (147 percent of the Federal poverty line).

(iii) Because X and Y are married but do not file a joint return for 2014, X and Y are not applicable taxpayers and are not allowed a premium tax credit for 2014. See §1.36B–2(b)(2). Under paragraph (b)(4) of this section, half of the advance credit payments ($6,880/2 = $3,440) is allocated to X and half is allocated to Y for purposes of determining their excess advance payments. The repayment limitation described in paragraph (a)(3) of this section applies to X and Y based on the household income and family size reported on each return. Consequently, X's tax liability for 2014 is increased by $2,500 and Y's tax liability for 2014 is increased by $600.

Example 9. (i) The facts are the same as in *Example 8* of paragraph (b)(5) of this section, except that X and Y live apart for over 6 months of the year and X properly files an income tax return as head of household. Under section 7703(b), X is treated as unmarried and therefore is not required to file a joint return. If X otherwise qualifies as an applicable taxpayer, X may claim the premium tax credit based on the household income and family size X reports on the return. Y is not an applicable taxpayer and is not eligible to claim the premium tax credit.

(ii) X must reconcile the amount of credit with advance credit payments under paragraph (a) of this section. The premium for the applicable benchmark plan covering X and his two dependents is $9,800. X's premium tax credit is computed as follows: $9,800 benchmark plan premium minus X's contribution amount of $5,700 ($60,000 × .095) equals $4,100.

(iii) Under paragraph (b)(4) of this section, half of the advance payments ($6,880/2 = $3,440) is allocated to X and half is allocated to Y. Thus, X is entitled to $660 additional premium tax credit ($4,100 − $3,440). Y has $3,440 excess advance payments, which is limited to $600 under paragraph (a)(3) of this section.

Example 10. (i) A is married to B at the close of 2014 and they have no dependents. A and B are enrolled in a qualified health plan for 2014 with an annual premium of $10,000 and advance credit payments of $6,500. A is not eligible for minimum essential coverage (other than coverage described in section 5000A(f)(1)(C)) for any month in 2014. A is a victim of domestic abuse as described in §1.36B–2(b)(2)(iii). At the time A files her tax return for 2014, A is unable to file a joint return with B for 2014 because of the domestic abuse. A certifies on her 2014 return, in accordance with relevant instructions, that she is living apart from B and is unable to file a joint return because of domestic abuse. Thus, under §1.36B–2(b)(2)(ii), A satisfies the joint return filing requirement in section 36B(c)(1)(C) for 2014.

(ii) A's family size for 2014 for purposes of computing the premium tax credit is one, and A is the only member of her coverage family. Thus, A's benchmark plan for all months of 2014 is the second lowest cost silver plan offered by the Exchange for A's rating area that covers A. A's household income includes only A's modified adjusted gross income. Under paragraph (b)(4)(ii) of this section, A takes into account $5,000 ($10,000 x .50) of the premiums for the plan in which she was enrolled in determining her premium tax credit. Further, A must reconcile $3,250 ($6,500 x .50) of the advance credit payments for her coverage under paragraph (b)(4)(i) of this section.

(c) *Applicability date.* Paragraphs (a)(1)(ii), (a)(3)(iii), (a)(4), *Examples 4, 10, 11, 12, 13, 14,* and *15,* (b)(3), (b)(4), and (b)(5), *Examples 9* and *10* apply to taxable years beginning after December 31, 2013.

[T.D. 9590, 77 FR 30385, May 23, 2012; 77 FR 41048, July 12, 2012; 77 FR 41270, July 13, 2012, as amended by T.D. 9683, 79 FR 43627, July 28, 2014; T.D. 9822, 82 FR 34607, July 26, 2017]

§ 1.36B–5 Information reporting by Exchanges.

(a) *In general.* An Exchange must report to the Internal Revenue Service (IRS) information required by section 36B(f)(3) and this section relating to individual market qualified health plans in which individuals enroll through the Exchange. No reporting is required under this section for enrollment in plans through the Small Business Health Options Exchange.

(b) *Individual filing a return.* For purposes of this section, the terms *tax filer* and *responsible adult* describe the individual who is expected to be the taxpayer filing an income tax return for the year of coverage with respect to individuals enrolling in a qualified health plan. A tax filer is an individual on behalf of whom advance payments of the premium tax credit are made. A responsible adult is an individual on behalf of whom advance payments of the premium tax credit are not made. An individual may be a tax filer or responsible adult whether or not enrolled in coverage. If more than one family (within the meaning of §1.36B–1(d)) enrolls in the same qualified health plan, there is a tax filer or responsible adult for each family.

(c) *Information required to be reported*—(1) *Information reported annually.* An Exchange must report to the IRS the following information for each qualified health plan—

(i) The name, address, and taxpayer identification number (TIN), or date of birth if a TIN is not available, of the tax filer or responsible adult;

(ii) The name and TIN, or date of birth if a TIN is not available, of a tax filer's spouse;

(iii) The amount of the advance credit payments paid for coverage under the plan each month;

(iv) For plans for which advance credit payments are made, the premium (excluding the premium allocated to benefits in excess of essential health benefits, see §1.36B–3(j)) for the applicable benchmark plan for purposes of computing advance credit payments;

(v) Except as provided in paragraph (c)(3)(ii) of this section, for plans for which advance credit payments are not made, the premium (excluding the premium allocated to benefits in excess of essential health benefits, see §1.36B–3(j)) for the applicable benchmark plan that would apply to all individuals enrolled in the qualified health plan if advance credit payments were made for the coverage;

(vi) The name and TIN, or date of birth if a TIN is not available, and dates of coverage for each individual covered under the plan;

(vii) The coverage start and end dates of the qualified health plan;

(viii) The monthly premium for the plan in which the individuals enroll, however—

(A) The premium allocated to benefits in excess of essential health benefits is excluded, see §1.36B–3(j);

(B) The premium for a stand-alone dental plan allocated to pediatric dental benefits is added, see §1.36B–3(k), but if a family (within the meaning of §1.36B–1(d)) is enrolled in more than one qualified health plan, the pediatric dental premium is added to the premium for only one qualified health plan; and

(C) The amount is not reduced for advance credit payments;

(ix) The name of the qualified health plan issuer;

(x) The Exchange-assigned policy identification number;

(xi) The Exchange's unique identifier; and

(xii) Any other information specified by forms or instructions or in published guidance, see §601.601(d) of this chapter.

(2) *Information reported monthly*. For each calendar month, an Exchange must report to the IRS for each qualified health plan, the information described in paragraph (c)(1) of this section and the following information—

(i) For plans for which advance credit payments are made—

(A) The names, TINs, or dates of birth if no TIN is available, of the individuals enrolled in the qualified health plan who are expected to be the tax filer's dependent; and

(B) Information on employment (to the extent this information is provided to the Exchange) consisting of—

(*1*) The name, address, and EIN of each employer of the tax filer, the tax filer's spouse, and each individual covered by the plan; and

(*2*) An indication of whether an employer offered affordable minimum essential coverage that provided minimum value, and, if so, the amount of the employee's required contribution for self-only coverage;

(ii) The unique identifying number the Exchange uses to report data that enables the IRS to associate the data with the proper account from month to month;

(iii) The issuer's employer identification number (EIN); and

(iv) Any other information specified by forms or instructions or in published guidance, see §601.601(d) of this chapter.

(3) *Special rules for information reported*—(i) *Multiple families enrolled in a single qualified health plan*. An Exchange must report the information specified in paragraphs (c)(1) and (c)(2) of this section for each family (within the meaning of §1.36B–1(d)) enrolled in a qualified health plan, including families submitting a single application or enrolled in a single qualified health plan. If advance credit payments are made for coverage under the plan, the enrollment premiums reported to each family under paragraph (c)(1)(viii) of this section are the premiums allocated to the family under §1.36B–3(h) (allocating enrollment premiums to each taxpayer in proportion to the premiums for each taxpayer's applicable benchmark plan).

(ii) *Alternative to reporting applicable benchmark plan*. An Exchange satisfies the requirement in paragraph (c)(1)(v) of this section if, on or before January 1 of each year after 2014, the Exchange provides a reasonable method that a responsible adult may use to determine the premium (after adjusting for benefits in excess of essential health benefits) for the applicable benchmark plan that applies to the responsible adult's coverage family for the prior calendar year for purposes of determining the premium tax credit on the tax return.

(iii) *Partial month of coverage.*—(A) *In general.* Except as provided in paragraph (c)(3)(iii)(B) of this section, if an individual is enrolled in a qualified health plan after the first day of a month, the amount reported for that month under paragraphs (c)(1)(iv), (c)(1)(v), and (c)(1)(viii) of this section is $0.

(B) *Certain mid-month enrollments.* For information reporting that is due on or after January 1, 2019, if an individual's qualified health plan is terminated before the last day of a month, or if an individual is enrolled in coverage after the first day of a month and the coverage is effective on the date of the individual's birth, adoption, or placement for adoption or in foster care, or on the effective date of a court order, the amount reported under paragraphs (c)(1)(iv) and (c)(1)(v) of this section is the premium for the applicable benchmark plan for a full month of coverage (excluding the premium allocated to benefits in excess of essential health benefits), and the amount reported under paragraph (c)(1)(viii) of this section is the enrollment premium for the month, reduced by any amounts that were refunded.

(4) *Exemptions.* For each calendar month, an Exchange must report to the IRS the name and TIN, or date of birth if a TIN is not available, of each individual for whom the Exchange has granted an exemption from coverage under section 5000A(e) and the related regulations, the months for which the exemption is in effect, and the exemption certificate number.

(d) *Time for reporting*—(1) *Annual reporting.* An Exchange must submit to the IRS the annual report required under paragraph (c)(1) of this section on or before January 31 of the year following the calendar year of coverage.

(2) *Monthly reporting*—(i) *In general.* Except as provided in paragraph (d)(2)(ii) of this section, an Exchange must submit to the IRS the monthly reports required under paragraphs (c)(2) and (c)(4) of this section on or before the 15th day following each month of coverage.

(ii) *Initial monthly reporting in 2014.* Exchanges must submit to the IRS the initial monthly report required under paragraphs (c)(2) and (c)(4) of this section on a date that the Commissioner may establish in other guidance, see §601.601(d) of this section, but no earlier than June 15, 2014. The initial report must include cumulative information for enrollments for the period January 1, 2014, through the last day of the month preceding the month for submitting the initial monthly report.

(3) *Corrections to information reported.* In general, an Exchange must correct erroneous or outdated monthly-reported information in the next monthly report. If the information must be corrected after the final monthly submission on January 15 following the coverage year, corrections should be submitted by the 15th day of the month following the month in which the incorrect information is identified. However, no monthly report correction is permitted after April 15 following the year of coverage. Errors on the annual report must be corrected and reported to the IRS and to the individual recipient identified in paragraph (f) of this section as soon as possible.

(e) *Electronic reporting.* An Exchange must submit the reports to the IRS required under this section in electronic format. The information reported monthly will be submitted to the IRS through the Department of Health and Human Services.

(f) *Annual statement to be furnished to individuals*—(1) *In general.* An Exchange must furnish to each tax filer or responsible adult (the recipient for purposes of paragraphs (f) and (g) of this section) a written statement showing—

(i) The name and address of the recipient and

(ii) The information described in paragraph (c)(1) of this section for the previous calendar year.

(2) *Form of statements.* A statement required under this paragraph (f) may be made by furnishing to the recipient identified in the annual report either a copy of the report filed with the IRS or

a substitute statement. A substitute statement must include the information required to be shown on the report filed with the IRS and must comply with requirements in published guidance (see § 601.601(d)(2) of this chapter) relating to substitute statements. A reporting entity may use an IRS truncated taxpayer identification number as the identification number for an individual in lieu of the identification number appearing on the corresponding information report filed with the IRS.

(3) *Time and manner for furnishing statements.* An Exchange must furnish the statements required under this paragraph (f) on or before January 31 of the year following the calendar year of coverage. If mailed, the statement must be sent to the recipient's last known permanent address or, if no permanent address is known, to the recipient's temporary address. For purposes of this paragraph (f)(3), an Exchange's first class mailing to the last known permanent address, or if no permanent address is known, the temporary address, discharges the Exchange's requirement to furnish the statement. An Exchange may furnish the statement electronically in accordance with paragraph (g) of this section.

(g) *Electronic furnishing of statements*—(1) *In general.* An Exchange required to furnish a statement under paragraph (f) of this section may furnish the statement to the recipient in an electronic format in lieu of a paper format. An Exchange that meets the requirements of paragraphs (g)(2) through (g)(7) of this section is treated as furnishing the statement in a timely manner.

(2) *Consent*—(i) *In general.* A recipient must have affirmatively consented to receive the statement in an electronic format. The consent may be made electronically in any manner that reasonably demonstrates that the recipient is able to access the statement in the electronic format in which it will be furnished. Alternatively, the consent may be made in a paper document that is confirmed electronically.

(ii) *Withdrawal of consent.* The consent requirement of this paragraph (g)(2) is not satisfied if the recipient withdraws the consent and the withdrawal takes effect before the statement is furnished. An Exchange may provide that the withdrawal of consent takes effect either on the date the Exchange receives it or on another date no more than 60 days later. The Exchange may provide that a request by the recipient for a paper statement will be treated as a withdrawal of consent to receive the statement in an electronic format. If the Exchange furnishes a statement after the withdrawal of consent takes effect, the recipient has not consented to receive the statement in electronic format.

(iii) *Change in hardware or software requirements.* If a change in the hardware or software required to access the statement creates a material risk that a recipient will not be able to access a statement, an Exchange must, prior to changing the hardware or software, notify the recipient. The notice must describe the revised hardware and software required to access the statement and inform the recipient that a new consent to receive the statement in the revised electronic format must be provided to the Exchange. After implementing the revised hardware and software, the Exchange must obtain a new consent or confirmation of consent from the recipient to receive the statement electronically.

(iv) *Examples.* The following examples illustrate the rules of this paragraph (g)(2):

Example 1. Furnisher F sends Recipient R a letter stating that R may consent to receive the statement required under section 36B electronically on a Web site instead of in a paper format. The letter contains instructions explaining how to consent to receive the statement electronically by accessing the Web site, downloading and completing the consent document, and emailing the completed consent to F. The consent document posted on the Web site uses the same electronic format that F will use for the electronically furnished statement. R reads the instructions and submits the consent in the manner provided in the instructions. R has consented to receive the statement required under section 36B electronically in the manner described in paragraph (g)(2)(i) of this section.

Example 2. Furnisher F sends Recipient R an email stating that R may consent to receive the statement required under section 36B electronically instead of in a paper format. The email contains an attachment instructing R how to consent to receive the statement required under section 36B electronically. The email attachment uses the same electronic format that F will use for the electronically furnished statement. R opens the attachment, reads the instructions, and submits the consent in the manner provided in the instructions. R has consented to receive the statement required under section 36B electronically in the manner described in paragraph (g)(2)(i) of this section.

Example 3. Furnisher F posts a notice on its Web site stating that Recipient R may receive the statement required under section 36B electronically instead of in a paper format. The Web site contains instructions on how R may access a secure Web page and consent to receive the statements electronically. R accesses the secure Web page and follows the instructions for giving consent. R has consented to receive the statement required under section 36B electronically in the manner described in paragraph (g)(2)(i) of this section.

(3) *Required disclosures*—(i) *In general.* Prior to, or at the time of, a recipient's consent, an Exchange must provide to the recipient a clear and conspicuous disclosure statement containing each of the disclosures described in paragraphs (g)(3)(ii) through (g)(3)(viii) of this section.

(ii) *Paper statement.* An Exchange must inform the recipient that the statement will be furnished on paper if the recipient does not consent to receive it electronically.

(iii) *Scope and duration of consent.* An Exchange must inform the recipient of the scope and duration of the consent. For example, the Exchange must inform the recipient whether the consent applies to each statement required to be furnished after the consent is given until it is withdrawn or only to the first statement required to be furnished following the consent.

(iv) *Post-consent request for a paper statement.* An Exchange must inform the recipient of any procedure for obtaining a paper copy of the recipient's statement after giving the consent described in paragraph (g)(2)(i) of this section and whether a request for a paper statement will be treated as a withdrawal of consent.

(v) *Withdrawal of consent.* An Exchange must inform the recipient that—

(A) The recipient may withdraw consent by writing (electronically or on paper) to the person or department whose name, mailing address, telephone number, and email address is provided in the disclosure statement;

(B) An Exchange will confirm the withdrawal and the date on which it takes effect in writing (either electronically or on paper); and

(C) A withdrawal of consent does not apply to a statement that was furnished electronically in the manner described in this paragraph (g) before the date on which the withdrawal of consent takes effect.

(vi) *Notice of termination.* An Exchange must inform the recipient of the conditions under which the Exchange will cease furnishing statements electronically to the recipient.

(vii) *Updating information.* An Exchange must inform the recipient of the procedures for updating the information needed to contact the recipient and notify the recipient of any change in the Exchange's contact information.

(viii) *Hardware and software requirements.* An Exchange must provide the recipient with a description of the hardware and software required to access, print, and retain the statement, and the date when the statement will no longer be available on the Web site. The Exchange must advise the recipient that the statement may be required to be printed and attached to a Federal, State, or local income tax return.

(4) *Format.* The electronic version of the statement must contain all required information and comply with applicable published guidance (see §601.601(d) of this chapter) relating to substitute statements to recipients.

(5) *Notice*—(i) *In general.* If a statement is furnished on a Web site, the Exchange must notify the recipient. The notice may be delivered by mail, electronic mail, or in person. The notice must provide instructions on how to access and print the statement and include the following statement in capital letters, "IMPORTANT TAX RETURN DOCUMENT AVAILABLE." If the notice is provided by electronic mail, this statement must be on the subject line of the electronic mail.

(ii) *Undeliverable electronic address.* If an electronic notice described in paragraph (g)(5)(i) of this section is returned as undeliverable, and the Exchange cannot obtain the correct electronic address from the Exchange's records or from the recipient, the Exchange must furnish the notice by mail or in person within 30 days after the electronic notice is returned.

(iii) *Corrected statement.* An Exchange must furnish a corrected statement to the recipient electronically if the original statement was furnished electronically. If the original statement was furnished through a Web site posting, the Exchange must notify the recipient that it has posted the corrected statement on the Web site in the manner described in paragraph (g)(5)(i) of this section within 30 days of the posting. The corrected statement or the notice must be furnished by mail or in person if—

(A) An electronic notice of the Web site posting of an original statement or the corrected statement was returned as undeliverable; and

(B) The recipient has not provided a new email address.

(6) *Access period.* Statements furnished on a Web site must be retained on the Web site through October 15 of the year following the calendar year to which the statements relate (or the first business day after October 15, if October 15 falls on a Saturday, Sunday, or legal holiday). The furnisher must maintain access to corrected statements that are posted on the Web site through October 15 of the year following the calendar year to which the statements relate (or the first business day after October 15, if October 15 falls on a Saturday, Sunday, or legal holiday) or the date 90 days after the corrected forms are posted, whichever is later.

(7) *Paper statements after withdrawal of consent.* An Exchange must furnish a paper statement if a recipient withdraws consent to receive a statement electronically and the withdrawal takes effect before the statement is furnished. A paper statement furnished under this paragraph (g)(7) after the statement due date is timely if furnished within 30 days after the date the Exchange receives the withdrawal of consent.

(h) *Effective/applicability date.* Except for the last sentence of paragraph (c)(3)(i) of this section and paragraph (c)(3)(iii) of this section, this section applies to taxable years ending after December 31, 2013. The last sentence of paragraph (c)(3)(i) of this section and paragraph (c)(3)(iii) of this section apply to taxable years beginning after December 31, 2018. Paragraph (c)(3) of §1.36B–5 as contained in 26 CFR part I edition revised as of April 1, 2016, applies to information reporting for taxable years ending after December 31, 2013, and beginning before January 1, 2019.

[T.D. 9663, 79 FR 26117, May 7, 2014, as amended at 81 FR 91768, Dec. 19, 2016]

§ 1.36B–6 Minimum value.

(a) *In general.* An eligible employer-sponsored plan provides minimum value (MV) only if—

(1) The plan's share of the total allowed costs of benefits provided to an employee (the MV percentage) is at least 60 percent; and

(2) [Reserved]

(b) *MV standard population.* [Reserved]

(c) *MV percentage*—(1) *In general.* [Reserved]

(2) *Wellness program incentives*—(i) *In general.* Nondiscriminatory wellness program incentives offered by an eligible employer-sponsored plan that affect deductibles, copayments, or other cost-sharing are treated as earned in determining the plan's MV percentage if the incentives relate exclusively to tobacco use. Wellness program incentives that do not relate to tobacco use or that include a component unrelated to tobacco use are treated as not earned for this purpose. For purposes of this section, the term *wellness program incentive* has the same meaning as the term *reward* in §54.9802–1(f)(1)(i) of this chapter.

(ii) *Example.* The following example illustrates the rules of this paragraph (c)(2):

Example. (i) Employer X offers an eligible employer-sponsored plan that reduces the deductible by $300 for employees who do not use tobacco products or who complete a smoking cessation course. The deductible is reduced by $200 if an employee completes cholesterol screening within the first six months of the plan year. Employee B does not use tobacco and his deductible is $3,700. Employee C uses tobacco and her deductible is $4,000.

(ii) Under paragraph (c)(2)(i) of this section, only the incentives related to tobacco use are considered in determining the plan's MV percentage. C is treated as having earned the $300 incentive for attending a smoking cessation course regardless of whether C actually attends the course. Thus, the deductible for determining for the MV percentage for both Employees B and C is $3,700. The $200 incentive for completing cholesterol screening is disregarded.

(3) *Employer contributions to health savings accounts.* Employer contributions for the current plan year to health savings accounts that are offered with an eligible employer-sponsored plan are taken into account for that plan year towards the plan's MV percentage.

(4) *Employer contributions to health reimbursement arrangements.* Amounts newly made available for the current plan year under a health reimbursement arrangement that would be integrated within the meaning of Notice 2013–54 (2013–40 IRB 287), see §601.601(d) of this chapter, with an eligible employer-sponsored plan for an employee enrolled in the plan are taken into account for that plan year towards the plan's MV percentage if the amounts may be used to reduce only cost-sharing for covered medical expenses. A health reimbursement arrangement counts toward a plan's MV percentage only if the health reimbursement arrangement and the eligible employer-sponsored plan are offered by the same employer. Employer contributions to a health reimbursement arrangement count for a plan year towards the plan's MV percentage only to the extent the amount of the annual contribution is required under the terms of the plan or otherwise determinable within a reasonable time before the employee must decide whether to enroll in the eligible employer-sponsored plan.

(5) *Expected spending adjustments for health savings accounts and health reimbursement arrangements.* [Reserved]

(d) *Methods for determining MV.* [Reserved]

(e) *Scope of essential health benefits and adjustment for benefits not included in MV Calculator.* [Reserved]

(f) *Actuarial certification.* [Reserved]

(1) *In general.* [Reserved]

(2) *Membership in American Academy of Actuaries.* [Reserved]

(3) *Actuarial analysis.* [Reserved]

(4) *Use of MV Calculator.* [Reserved]

(g) *Effective/applicability date—in general.* (1) Except as provided in paragraph (g)(2) of this section, this section applies for taxable years ending after December 31, 2013.

(2) *Exception.* [Reserved]

[T.D. 9745, 80 FR 78976, Dec. 18, 2015]

§ 1.37–1 General rules for the credit for the elderly.

(a) *In general.* In the case of an individual, section 37 provides a credit against the tax imposed by chapter 1 of the Internal Revenue Code of 1954. This section and §§1.37–2 and 1.37–3 provide guidance in the computation of the credit for the elderly provided under section 37 for taxable years beginning after 1975. For rules relating to the computation of the retirement income credit provided under section 37 for taxable years beginning before 1976, see 26 CFR 1.37–1 through 1.37–5 (Rev. as of April 1, 1980). Note that section 403 of the Tax Reduction and Simplification Act of 1977 provides that a taxpayer may elect to compute the credit under section 37 for the taxpayer's first taxable year beginning in 1976 in accordance with the rules applicable to taxable years beginning before 1976.

(b) *Limitation on the amount of the credit.* The credit allowed by section 37 for a taxable year shall not exceed the tax imposed by chapter 1 of the Code for the taxable year (reduced, in the case of a taxable year beginning before 1979, by the general tax credit allowed by section 42).

(c) *Married couples must file joint returns.* If the taxpayer is married at the close of the taxable year, the credit provided by section 37 shall be allowed only if the taxpayer and the taxpayer's spouse file a joint return for the taxable year. The preceding sentence shall not apply in the case of a husband and wife who are not members of the same household at any time during the taxable year. For the determination of marital status, see §§ 143 and 1.143–1.

(d) *Nonresident aliens ineligible.* No credit is allowed under section 37 to any individual for any taxable year during which that individual is at any time a nonresident alien unless the individual is treated, by reason of an election under section 6013 (g) or (h), as a resident of the United States for that taxable year.

[T.D. 7743, 45 FR 84049, Dec. 22, 1980]

§ 1.37–2 Credit for individuals age 65 or over.

(a) *In general.* This section illustrates the computation of the credit for the elderly in the case of an individual who has attained the age of 65 before the close of the taxable year. This section shall not apply to an individual for any taxable year for which the individual makes the election described in section 37(e)(2) and paragraph (b) of § 1.37–3.

(b) *Computation of credit.* The credit for the elderly for an individual to whom this section applies equals 15 percent of the individual's ''section 37 amount'' for the taxable year. An individual's ''section 37 amount'' for a taxable year is the initial amount determined under section 37(b)(2), reduced as provided in section 37(b)(3) and (c)(1).

(c) *Examples.* The computation of the credit for the elderly for individuals to whom this section applies may be illustrated by the following examples:

Example 1. A, a single individual who is 67 years old, has adjusted gross income of $8,000 for the calendar year 1977. A also receives social security payments of $1,450 during 1977. A does not itemize deductions. A's credit for the elderly is $120, computed as follows:

Initial amount under section 37(b)(2)		$2,500
Reductions required by section 37 (b)(3) and (c)(1):		
Social security payments	$1,450	
One-half the excess of adjusted gross income over $7,500	250	1,700
Section 37 amount		800
15 pct. of $800		$120

A's tax from the tax tables, which reflect the allowance of the general tax credit, is $662. Accordingly, the limitation of section 37(c)(2) and paragraph (b) of § 1.37–1 does not reduce A's credit for the elderly.

Example 2. H and W, who have both attained the age of 65, file a joint return for calendar year 1977. For that year H and W have adjusted gross income of $8,120; H also receives a railroad retirement pension of $1,550, and W receives social security payments of $1,200. H and W do not itemize deductions. The credit for the elderly allowed to H and W for 1977 is $139, computed as follows:

Initial amount under section 37(b)(2)		$3,750
Reductions required by section 37 (b)(3):		
Railroad retirement pension	$1,550	
Social Security payments	1,200	2,750
Section 37 amount		1,000
15 pct. of $1,000		150
Limitation based upon amount of tax (derived from table reflecting allowance of general tax credit)		$139

Since the adjusted gross income of H and W is not greater than $10,000, no reduction of the initial amount is required under section 37 (c)(1).

[T.D. 7743, 45 FR 84050, Dec. 22, 1980]

§ 1.37–3 Credit for individuals under age 65 who have public retirement system income.

(a) *In general.* This section provides rules for the computation of the credit for the elderly under section 37(e) in the case of an individual who has not attained the age of 65 before the close of the taxable year and whose gross income for the taxable year includes retirement income within the meaning of paragraph (d)(1)(ii) of this section (*i.e.*, under a public retirement system). If such an individual is married within the meaning of section 143 at the close of the taxable year and the spouse of the individual has attained the age of 65 before the close of the taxable year, this section shall apply to the individual for the taxable year only if both spouses make the election described in paragraph (b) of this section. If both spouses make the election described in paragraph (b) of this section for the taxable year, the credit of each spouse shall be determined under the rules of this section. See paragraph (f)(2) of this section for a limitation on the effects of community property laws in making determinations and computations under section 37(e) and this section.

(b) *Election by certain married taxpayers.* If a married individual under age 65 at the close of the taxable year has retirement income and the spouse of that individual has attained the age of 65 before the close of the taxable year, both spouses may elect to compute the credit provided by section 37 under the rules of section 37(e) and this section. The spouses shall signify the election on the return (or amended return) for the taxable year in the manner prescribed in the instructions accompanying the return. The election may be made at any time before the expiration of the period of limitation for filing claim for credit or return for the taxable year. The election may be revoked without the consent of the Commissioner at any time before the expiration of that period by filing an amended return.

(c) *Computation of credit.* The credit of an individual under section 37(e) and this section equals 15 percent of the individual's credit base for the taxable year. The credit base of an individual for a taxable year is the lesser of—

(1) The retirement income of the individual for the taxable year, or

(2) The amount determined under section 37(e)(5), as modified by section 37(e) (6) and (7).

(d) *Retirement income*—(1) *General rule*—(i) *For individuals 65 or over.* Section 37(e)(4)(A) enumerates the kinds of income which may be treated as the retirement income of an individual who has attained the age of 65 before the close of the taxable year. They include income from pensions and annuities, interest, rents, dividends, certain bonds received under a qualified bond purchase plan, and certain individual retirement accounts or annuities.

(ii) *For individuals under 65.* In the case of an individual who has not attained the age of 65 before the close of the taxable year, retirement income consists only of income from pensions and annuities (including disability annuity payments) under a public retirement system which arises from services performed by that individual or by a present or former spouse of that individual. The term "public retirement system" means a pension, annuity, or retirement, or similar fund or system established by the United States, a State, a possession of the United States, any political subdivision of any of the foregoing, or the District of Columbia.

(2) *Rents.* For purposes of section 37(e)(4)(A)(iii), income from rents shall be the gross amount received, not reduced by depreciation or other expenses, except that beneficiaries of a trust or estate shall treat as retirement income only their proportionate shares, of the taxable rents of the trust or estate. In the case of an amount received for board and lodging, only the portion of the amount received for lodging is income from rents.

(3) *Disability annuity payments received by individual under age 65.* Disability annuity payments received under a public retirement system by an individual under age 65 at the close of the taxable year shall not be treated as retirement income unless the payments are for periods after the date on which the individual reached minimum retirement age, that is, the age at which the individual would be eligible to receive a pension or annuity without regard to disability, and any of the following conditions is satisfied—

(i) The individual is precluded from seeking the benefits of section 105(d) (relating to certain disability payments) for that taxable year by reason of an irrevocable election;

(ii) The individual was not permanently and totally disabled at the time of retirement (and was not permanently and totally disabled either on January 1, 1976, or on January 1, 1977, if the individual retired before the later date on disability or under circumstances which entitled the individual to retire on disability); or

(iii) The payments are for periods after the individual reached mandatory retirement age.

For purposes of this paragraph, disability annuity payments include payments to an individual who retired on partial or temporary disability.

(4) *Compensation of personal services rendered during taxable year.* Retirement income does not include any amount representing compensation for personal services rendered during the taxable year. For this purpose, amounts received as a pension shall not be treated as representing compensation for personal services rendered during the taxable year if the period of service during the taxable year is not substantial when compared with

the total years of service. For example, an individual on the calendar year basis retires on November 30 after 5 years of service and receives a pension during the remainder of his taxable year. The pension is not treated as representing compensation for personal services rendered during such taxable year merely because it is paid by reason of the services of the individual for a period of 5 years which includes a portion of the taxable year.

(5) *Amounts not includible in gross income.* Retirement income does not include any amount not includible in the gross income of the individual for the taxable year. For example, if a portion of an annuity is excluded from gross income under section 72, relating to annuities, that portion of the annuity is not retirement income; similarly, the portion of dividend income excluded from gross income under section 116, relating to the partial exclusion of dividends received by individuals is not retirement income.

(e) *Earned income*—(1) *In general.* The term ''earned income'' in section 37(e)(5)(B) generally has the same meaning as in section 911(b), except that earned income does not include any amount received as a pension or annuity. See section 911(b) and the regulations thereunder. Section 911(b) provides, in general, that earned income includes wages, salaries, professional fees, and other amounts received as compensation for personal services rendered.

(2) *Earned income from self-employment.* For purposes of section 37(e)(5)(B), the earned income of a taxpayer from self-employment in a trade or business shall not exceed—

(i) The taxpayer's share of the net profits from the trade or business if capital is not a material income-producing factor in that trade or business; or

(ii) Thirty percent of the taxpayer's share of the net profits from the trade or business if capital is a material income-producing factor in that trade or business.

For other rules relating to the determination of earned income from self-employment in a trade or business, see section 911(b) and the regulations thereunder.

(3) *Disability annuity payments received by individuals under age 65.* Disability annuity payments received under a public retirement system by an individual under age 65 at the close of the taxable year shall be treated as earned income for purposes of section 37(e)(5)(B) unless the payments are treated as retirement income under paragraph (d)(3) of this section.

(f) *Computation of credit under section 37(e) in the case of joint returns*—(1) *In general.* In the case of a joint return of husband and wife, the credit base of each spouse under section 37(e) is computed separately. The spouses then combine their credit bases and compute a single credit. The limitation in section 37(c)(2) and paragraph (b) of §1.37–1 on the amount of the credit is determined by reference to the joint tax liability of the spouses. Thus, regardless of whether a spouse would be liable for the tax imposed by chapter 1 of the Code if the joint return had not been filed, the credit base of that spouse is taken into account in computing the credit.

(2) *Community property laws.* For taxable years beginning after 1977, married individuals filing joint returns shall disregard community property laws in making any determination or computation required under section 37(e) or this section. Each item of income is attributed in full to the spouse whose income it would have been in the absence of community property laws. Thus, if a 67-year old individual files a joint return with a 62-year old spouse for 1979 and the only income of the couple is from a public pension of the older spouse, that public pension is attributed in full to the older spouse for purposes of section 37(e) even though the applicable community property law may treat one-half of the pension as the income of the 62-year old spouse. Since the younger spouse consequently has no retirement income within the meaning of paragraph (d) of this section, the couple may not make the election described in paragraph (b) of this section.

(g) *Examples.* The computation of the credit for the elderly under section 37(e) and this section is illustrated by the following examples:

Example 1. B, who is 62 years old and single, receives a fully taxable pension of $2,400 from a public retirement system during 1977. B performed the services giving rise to the pension. During that year, B also earns $2,650 from a part-time job. B receives no tax-exempt pension or annuity in 1977. Subject to the limitation of section 37(c)(2) and paragraph (b) of §1.37–1, B's credit for the elderly for 1977 under section 37(e) is $195, computed as follows:

Maximum retirement income level under section 37(e)(5)		$2,500
Earned income offset under section 37(e)(5)(B)(ii):		
Earned income in excess of $1,700	$950	
One-half of earned income in excess of $1,200, but not in excess of $1,700	250	1,200
Amount determined under section 37(e)(5)		1,300
Retirement income		2,400
Credit for the elderly (15 pct. of $1,300)		195

Example 2. During 1978 H, who is 67 years old, has earnings of $1,300 and retirement income (rents, interest, etc.) of $6,000. H also receives social security payments totalling $1,400. During 1978 W, who is 63 years old, earns $1,600 and receives a fully taxable pension of $1,400 from a public retirement system that constitutes retirement income. W performed the services giving rise to the pension. H and W file a joint return for 1978 and elect to compute the credit for the elderly under section 37(e). Under the applicable law these items of income are community income, and both spouses share equally in each item. Because H and W are filing a joint return, they disregard community property laws in computing their credit under section 37(e). The couple allocates $1,600 of the $3,750 referred to in section 37(e)(6) to W and $2,150 to H. Subject to the limitation of section 37(c)(2) and paragraph (b) of §1.37–1, their credit for the elderly is $315, computed as follows:

Credit base of H:		
Amount allocated to H under section 37(e)(6)		$2,150
Reductions required by section 37(e)(5):		
Social Security payments	$1,400	
One-half of excess of earnings over $1,200	50	1,450
Amount determined under section 37(e)(5)		700
Retirement income		6,000
Credit base of H		700
Credit base of W:		
Amount allocated to W under section 37(e)(6)		$1,600
Reduction required by section 37(e)(5)(B):		
One-half of excess of earnings over $1,200		$200
Amount determined under section 37(e)(5)		1,400
Retirement income		1,400
Credit base of W		1,400
Computation of credit:		
Credit base of H		700
Credit base of W		1,400
Combined credit base		2,100
Credit for the elderly (15 pct. of $2,100)		315

Example 3. (a) Assume the same facts as in example (2) of this paragraph, except that H and W live apart at all times during 1978 and file separate returns. Under these circumstances, H and W must give effect to the applicable community property law in determining their credits under section 37(e). Thus, each spouse must take into account one-half of each item of income.

(b) Subject to the limitation of section 37(c)(2) and paragraph (b) of §1.37–1, H's credit for the elderly is $157.50, computed as follows:

Maximum retirement income level under section 37(e)(7)		$1,875
Reductions required by section 37(e)(5):		
Social security payments	$700	
One-half of excess of earnings over $1,200 (taking into account one-half of combined earnings of $2,900)	125	825
Amount determined under section 37(e)(5)		1,050
Retirement income		3,700
Credit of H (15 pct. of $1,050)		157.50

(c) Subject to the limitation of section 37(c)(2) and paragraph (b) of §1.37–1, W's credit for the elderly is computed as follows:

Maximum retirement income level under section 37(e)(7)		$1,875	
Reductions required by section 37(e)(5):			
Social security payments	$700		
One-half of excess of earnings over $1,200	125		825
Amount determined under section 37(e)(5)		1,050	
Retirement income (limited to W's share of public pension)		700	
Credit of W (15 pct. of $700)		105	

[T.D. 7743, 45 FR 84050, Dec. 22, 1980]

§ 1.38–1 Investment in certain depreciable property.

Regulations under sections 46 through 50 are prescribed under the authority granted the Secretary by section 38(b) to prescribe regulations as may be necessary to carry out the purposes of section 38 and subpart B, part IV, subchapter A, chapter 1 of the Code.

[44 FR 20417, Apr. 5, 1979]

§ 1.40–1 Questions and answers relating to the meaning of the term "qualified mixture" in section 40(b)(1).

Q–1. What is a ''qualified mixture'' within the meaning of section 40(b)(1)?

A–1. A ''qualified mixture'' is a mixture of alcohol and gasoline or of alcohol and special fuel which (1) is sold by the taxpayer producing such mixture to any person for use as a fuel, or (2) is used as a fuel by the taxpayer producing such mixture.

Q–2. Must alcohol be present in a product in order for that product to be considered a mixture of alcohol and either gasoline or a special fuel?

A–2. No. A product is considered to be a mixture of alcohol and gasoline or of alcohol and a special fuel if the product is derived from alcohol and either gasoline or a special fuel even if the alcohol is chemically transformed in producing the product so that the alcohol is no longer present as a separate chemical in the final product, provided that there is no significant loss in the energy content of the alcohol. Thus, a product may be considered to be ''mixture of alcohol and gasoline or of alcohol and a special fuel'' within the meaning of section 40(b)(1)(B) if such product is produced in a chemical reaction between alcohol and either gasoline or a special fuel. Similarly a product may be considered to be a ''mixture of alcohol and gasoline or of alcohol and a special fuel'' if such product is produced by blending a chemical compound derived from alcohol with either gasoline or a special fuel.

Thus, for example, a blend of gasoline and ethyl tertiary butyl ether (ETBE), a compound derived from ethanol (a qualified alcohol), in a chemical reaction in which there is no significant loss in the energy content of the ethanol, is considered for purposes of section 40(b)(1)(B) to be a mixture of gasoline and the ethanol used to produce the ETBE, even though the ethanol is chemically transformed in the production of ETBE and is not present in the final product.

[T.D. 8291, 55 FR 8948, Mar. 9, 1990]

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(b) Application of requirements for qualified research.
(1) In general.
(2) Shrinking-back rule.
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(1) In general.
(2) Research after commercial production.
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(6) Internal use software.
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(i) In general.
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(8) Research in the social sciences, etc.
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(d) Recordkeeping for the research credit.
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§ 1.41–5 Basic research for taxable years beginning after December 31, 1986. [Reserved]

§ 1.41–6 Aggregation of expenditures.

(a) Controlled groups of corporations; trades or businesses under common control.
(1) In general.
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(b) Computation of the group credit.
(1) In general.
(2) Start-up companies.
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(g) Tax accounting periods used.
(1) In general.
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(j) Effective/applicability dates.
(1) In general.
(2) Consolidated group rule.
(3) Taxable years ending after June 9, 2011.
(4) Taxable years beginning after December 31, 2011.
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§ 1.41–7 Special rules.

(a) Allocations.
(1) Corporation making an election under subchapter S.
(i) Pass-through, for taxable years beginning after December 31, 1982, in the case of an S corporation.
(ii) Pass-through, for taxable years beginning before January 1, 1983, in the case of a subchapter S corporation.
(2) Pass-through in the case of an estate or trust.
(3) Pass-through in the case of a partnership.
(i) In general.
(ii) Certain expenditures by joint ventures.

(4) Year in which taken into account.
(5) Credit allowed subject to limitation.
(b) Adjustments for certain acquisitions and dispositions—Meaning of terms.
(c) Special rule for pass-through of credit.
(d) Carryback and carryover of unused credits.

§ 1.41–8 Alternative incremental credit applicable for taxable years beginning on or before December 31, 2008.

(a) Determination of credit.
(b) Election.
(1) In general.
(2) Time and manner of election.
(3) Revocation.
(4) Special rules for controlled groups.
(i) In general.
(ii) Designated member.
(5) Effective/applicability dates.

§ 1.41–9 Alternative simplified credit.

(a) Determination of credit.
(b) Election.
(1) In general.
(2) Time and manner of election.
(3) Revocation.
(4) Special rules for controlled groups.
(i) In general.
(ii) Designated member.
(c) Special rules.
(1) Qualified research expenditures (QREs) required in all years.
(2) Section 41(c)(6) applicability.
(3) Short taxable years.
(i) General rule.
(ii) Limited exception.
(4) Controlled groups.
(d) Effective/applicability dates.

[T.D. 8930, 65 FR 287, Jan. 3, 2001, as amended by T.D. 9104, 69 FR 26, Jan. 2, 2004; T.D. 9205, 70 FR 29601, May 24, 2005; T.D. 9296, 71 FR 65725, Nov. 9, 2006; T.D. 9401, 73 FR 34187, June 17, 2008; T.D. 9528, 76 FR 33995, June 10, 2011; 80 FR 18098, Apr. 3, 2015; T.D. 9786, 81 FR 68306, Oct. 4, 2016]

§ 1.41–1 Credit for increasing research activities.

(a) *Amount of credit.* The amount of a taxpayer's credit is determined under section 41(a). For taxable years beginning after June 30, 1996, and at the election of the taxpayer, the portion of the credit determined under section 41(a)(1) may be calculated using the alternative incremental credit set forth in section 41(c)(4). For taxable years ending after December 31, 2006, and at the election of the taxpayer, the portion of the credit determined under section 41(a)(1) may be calculated using either the alternative incremental credit set forth in section 41(c)(4), or the alternative simplified credit set forth in section 41(c)(5).

(b) *Introduction to regulations under section 41.* (1) Sections 1.41–2 through 1.41–8 and 1.41–3A through 1.41–5A address only certain provisions of section 41. The following table identifies the provisions of section 41 that are addressed, and lists each provision with the section of the regulations in which it is covered.

Section of the regulation	Section of the Internal Revenue Code
§ 1.41–2	41(b).
§ 1.41–3	41(c).
§ 1.41–4	41(d).
§ 1.41–5	41(e).
§ 1.41–6	41(f).
§ 1.41–7	41(f). 41(g).
§ 1.41–8	41(c).
§ 1.41–3A	41(c) (taxable years beginning before January 1, 1990).
§ 1.41–4A	41(d) (taxable years beginning before January 1, 1986).
§ 1.41–5A	41(e) (taxable years beginning before January 1, 1987).

(2) Section 1.41–3A also addresses the special rule in section 221(d)(2) of the Economic Recovery Tax Act of 1981 relating to taxable years overlapping the effective dates of section 41. Section 41 was formerly designated as sections 30 and 44F. Sections 1.41–0 through 1.41–8 and 1.41–0A through 1.41–5A refer to these sections as section 41 for conformity purposes. Whether section 41, former section 30, or former section 44F applies to a particular expenditure depends upon when the expenditure was paid or incurred.

[T.D. 8930, 65 FR 288, Jan. 3, 2001, as amended by T.D. 9401, 73 FR 34187, June 17, 2008]

§ 1.41–2 Qualified research expenses.

(a) *Trade or business requirement*—(1) *In general.* An in-house research expense of the taxpayer or a contract research expense of the taxpayer is a qualified research expense only if the expense is paid or incurred by the taxpayer in carrying on a trade or business of the taxpayer. The phrase ''in carrying on a trade or business'' has the same meaning for purposes of section 41(b)(1) as it has for purposes of section 162; thus, expenses paid or incurred in connection with a trade or business within the meaning of section 174(a) (relating to the deduction for research and experimental expenses) are not necessarily paid or incurred in carrying on a trade or business for purposes of section 41. A research expense must relate to a particular trade or business being carried on by the taxpayer at the time the expense is paid or incurred in order to be a qualified research expense. For purposes of section 41, a contract research expense of the taxpayer is not a qualified research expense if the product or result of the research is intended to be transferred to another in return for license or royalty payments and the taxpayer does not use the product of the research in the taxpayer's trade or business.

(2) *New business.* Expenses paid or incurred prior to commencing a new business (as distinguished from expanding an existing business) may be paid or incurred in connection with a trade or business but are not paid or incurred in carrying on a trade or business. Thus, research expenses paid or incurred by a taxpayer in developing a product the sale of which would constitute a new trade or business for the taxpayer are not paid or incurred in carrying on a trade or business.

(3) *Research performed for others*—(i) *Taxpayer not entitled to results.* If the taxpayer performs research on behalf of another person and retains no substantial rights in the research, that research shall not be taken into account by the taxpayer for purposes of section 41. See §1.41–4A(d)(2).

(ii) *Taxpayer entitled to results.* If the taxpayer in carrying on a trade or business performs research on behalf of other persons but retains substantial rights in the research, the taxpayer shall take otherwise qualified expenses for that research into account for purposes of section 41 to the extent provided in §1.41–4A(d)(3).

(4) *Partnerships*—(i) *In general.* An inhouse research expense or a contract research expense paid or incurred by a partnership is a qualified research expense of the partnership if the expense is paid or incurred by the partnership in carrying on a trade or business of the partnership, determined at the partnership level without regard to the trade or business of any partner.

(ii) *Special rule for certain partnerships and joint ventures.* (A) If a partnership or a joint venture (taxable as a partnership) is not carrying on the trade or business to which the research relates, then the general rule in paragraph (a)(4)(i) of this section would not allow any of such expenditures to qualify as qualified research expenses.

(B) Notwithstanding paragraph (a)(4)(ii)(A) of this section, if all the partners or venturers are entitled to make independent use of the results of the research, this paragraph (a)(4)(ii) may allow a portion of such expenditures to be treated as qualified research expenditures by certain partners or venturers.

(C) First, in order to determine the amount of credit that may be claimed by certain partners or venturers, the amount of qualified research expenditures of the partnership or joint venture is determined (assuming for this purpose that the partnership or joint venture is carrying on the trade or business to which the research relates).

(D) Second, this amount is reduced by the proportionate share of such expenses allocable to those partners or venturers who would not be able to claim such expenses as qualified research expenditures if they had paid or incurred such expenses directly. For this purpose such partners' or venturers' proportionate share of such expenses shall be determined on the basis of such partners' or venturers' share of partnership items of income or gain (excluding gain allocated under section 704(c)) which results in the largest proportionate share. Where a partner's or venturer's share of partnership items of income or gain (excluding gain allocated under section 704(c)) may vary during the period such partner or venturer is a partner or venturer in such partnership or joint venture, such share shall be the highest share such partner or venturer may receive.

(E) Third, the remaining amount of qualified research expenses is allocated among those partners or venturers who would have been entitled to claim a credit for such expenses if they had paid or incurred the research expenses in their own trade or business, in the relative proportions that such partners or venturers share deductions for expenses under section 174 for the taxable year that such expenses are paid or incurred.

(F) For purposes of section 41, research expenditures to which this paragraph (a)(4)(ii) applies shall be treated as paid or incurred directly by such partners or venturers. See § 1.41–7(a)(3)(ii) for special rules regarding these expenses.

(iii) The following examples illustrate the application of the principles contained in paragraph (a)(4)(ii) of this section.

Example 1. A joint venture (taxable as a partnership) is formed by corporations A, B, and C to develop and market a supercomputer. A and B are in the business of developing computers, and each has a 30 percent distributive share of each item of income, gain, loss, deduction, credit and basis of the joint venture. C, which is an investment banking firm, has a 40 percent distributive share of each item of income, gain, loss, deduction, credit and basis of the joint venture. The joint venture agreement provides that A's, B's and C's distributive shares will not vary during the life of the joint venture, liquidation proceeds are to be distributed in accordance with the partners' capital account balances, and any partner with a deficit in its capital account following the distribution of liquidation proceeds is required to restore the amount of such deficit to the joint venture. Assume in Year 1 that the joint venture incurs $100x of ''qualified research expenses.'' Assume further that the joint venture cannot claim the research credit for such expenses because it is not carrying on the trade or business to which the research relates. In addition A, B, and C are all entitled to make independent use of the results of the research. First, the amount of qualified research expenses of the joint venture is $100x. Second, this amount is reduced by the proportionate share of such expenses allocable to C, the venturer which would not have been able to claim such expenses as qualified research expenditures if it had paid or incurred them directly, C's proportionate share of such expenses is $40x (40% of $100x). The reduced amount is $60x. Third, the remaining $60x of qualified research expenses is allocated between A and B in the relative proportions that A and B share deductions for expenses under section 174. A is entitled to treat $30x ((30%/(30% + 30%)) $60x) as a qualified research expense. B is also entitled to treat $30x ((30%/(30% + 30%)) $60x) as a qualified research expense.

Example 2. Assume the same facts as in example (1) except that the joint venture agreement provides that during the first 2 years of the joint venture, A and B are each allocated 10 percent of each item of income, gain, loss, deduction, credit and basis, and C is allocated 80 percent of each item of income, gain, loss, deduction, credit and basis. Thereafter the allocations are the same as in example (1). Assume for purposes of this example that such allocations have substantial economic effect for purposes of section 704 (b). C's highest share of such items during the life of the joint venture is 80 percent. Therefore C's proportionate share of the joint venture's qualified research expenses is $80x (80% of $100x). The reduced amount of qualified research expenses is $20x ($100x − $80x). A is entitled to treat $10x ((10%/(10% + 10%)) $20x) as a qualified research expense in Year 1. B is also entitled to treat $10x ((10%/(10% + 10%)) $20x) as a qualified research expense in Year 1.

(b) *Supplies and personal property used in the conduct of qualified research*—(1) *In general.* Supplies and personal property (except to the extent provided in paragraph (b)(4) of this section) are used in the conduct of qualified research if they are used in the performance of qualified services (as defined in section 41(b)(2)(B), but without regard to the last sentence thereof) by an employee of the taxpayer (or by a person acting in a capacity similar to that of an employee of the taxpayer; see example (6) of § 1.41–2(e)(5)). Expenditures for supplies or for the use of personal property that are indirect research expenditures or general and administrative expenses do not qualify as inhouse research expenses.

(2) *Certain utility charges*—(i) *In general.* In general, amounts paid or incurred for utilities such as water, electricity, and natural gas used in the building in which qualified research is performed are treated as expenditures for general and administrative expenses.

(ii) *Extraordinary expenditures.* To the extent the taxpayer can establish that the special character of the qualified research required additional extraordinary expenditures for utilities, the additional expenditures shall be treated as amounts paid or incurred for supplies used in the conduct of qualified research. For example, amounts paid for electricity used for general laboratory lighting are treated as general and administrative expenses, but amounts paid for electricity used in operating high energy equipment for qualified research (such as laser or nuclear research) may be treated as expenditures for supplies used in the conduct of qualified research to the extent the taxpayer can establish that the special character of the research required an extraordinary additional expenditure for electricity.

(3) *Right to use personal property.* The determination of whether an amount is paid to or incurred for another person for the right to use personal property in the conduct of qualified research shall be made without regard to the characterization of the transaction as a lease under section 168(f)(8) (as that section read before it was repealed by the Tax Reform Act of 1986). See § 5c.168(f)(8)–1(b).

(4) *Use of personal property in taxable years beginning after December 31, 1985.* For taxable years beginning after December 31, 1985, amounts paid or incurred for the use of personal property are not qualified research expenses, except for any amount paid or incurred to another person for the right to use (time-sharing) computers in the conduct of qualified research. The computer must be owned and operated by someone other than the taxpayer, located off the taxpayer's premises, and the taxpayer must not be the primary user of the computer.

(c) *Qualified services*—(1) *Engaging in qualified research.* The term ''engaging in qualified research'' as used in section 41(b)(2)(B) means the actual conduct of qualified research (as in the case of a scientist conducting laboratory experiments).

(2) *Direct supervision.* The term ''direct supervision'' as used in section 41(b)(2)(B) means the immediate supervision (first-line management) of qualified research (as in the case of a research scientist who directly supervises laboratory experiments, but who may not actually perform experiments). ''Direct supervision'' does not include supervision by a higher-level manager to whom first-line managers report, even if that manager is a qualified research scientist.

(3) *Direct support.* The term ''direct support'' as used in section 41(b)(2)(B) means services in the direct support of either—

(i) Persons engaging in actual conduct of qualified research, or

(ii) Persons who are directly supervising persons engaging in the actual conduct of qualified research. For example, direct support of research includes the services of a secretary for typing reports describing laboratory results derived from qualified research, of a laboratory worker for cleaning equipment used in qualified research, of a clerk for compiling research data, and of a machinist for machining a part of an experimental model used in qualified research. Direct support of research activities does not include general administrative services, or other services only indirectly of benefit to research activities. For example, services of payroll personnel in preparing salary checks of laboratory scientists, of an accountant for accounting for research expenses, of a janitor for general cleaning of a research laboratory, or of officers engaged in supervising financial or personnel matters do not qualify as direct support of research. This is true whether general administrative personnel are part of the research department or in a separate department. Direct support does not include supervision. Supervisory services constitute ''qualified services'' only to the extent provided in paragraph (c)(2) of this section.

(d) *Wages paid for qualified services*—(1) *In general.* Wages paid to or incurred for an employee constitute in-house research expenses only to the extent the wages were paid or incurred for qualified services performed by the employee. If an employee has performed both qualified services and nonqualified services, only the amount of wages allocated to the performance of qualified services constitutes an inhouse research expense. In the absence of another method of allocation that the taxpayer can demonstrate to be more appropriate, the amount of inhouse research expense shall be determined by multiplying the total amount of wages paid to or incurred for the employee during the taxable year by the ratio of the total time actually spent by the employee in the performance of qualified services for the taxpayer to the total time spent by the employee in the performance of all services for the taxpayer during the taxable year.

(2) ''*Substantially all.*'' Notwithstanding paragraph (d)(1) of this section, if substantially all of the services performed by an employee for the taxpayer during the taxable year consist of services meeting the requirements of section 41(b)(2)(B) (i) or (ii), then the term ''qualified services'' means all of the services performed by the employee for the taxpayer during the taxable year. Services meeting the requirements of section 41(b)(2)(B) (i) or (ii) constitute substantially all of the services performed by the employee during a taxable year only if the wages allocated (on the basis used for purposes of paragraph (d)(1) of this section) to services meeting the requirements of section 41(b)(2)(B) (i) or (ii) constitute at least 80 percent of the wages paid to or incurred by the taxpayer for the employee during the taxable year.

(e) *Contract research expenses*—(1) *In general.* A contract research expense is 65 percent of any expense paid or incurred in carrying on a trade or business to any person other than an employee of the taxpayer for the performance on behalf of the taxpayer of—

(i) Qualified research as defined in § 1.41–4 or 1.41–4A, whichever is applicable, or

(ii) Services which, if performed by employees of the taxpayer, would constitute qualified services within the meaning of section 41(b)(2)(B).

Where the contract calls for services other than services described in this paragraph (e)(1), only 65 percent of the portion of the amount paid or incurred that is attributable to the services described in this paragraph (e)(1) is a contract research expense.

(2) *Performance of qualified research.* An expense is paid or incurred for the performance of qualified research only to the extent that it is paid or incurred pursuant to an agreement that—

(i) Is entered into prior to the performance of the qualified research,

(ii) Provides that research be performed on behalf of the taxpayer, and

(iii) Requires the taxpayer to bear the expense even if the research is not successful.

If an expense is paid or incurred pursuant to an agreement under which payment is contingent on the success of the research, then the expense is considered paid for the product or result rather than the performance of the research, and the payment is not a contract research expense. The previous sentence applies only to that portion of a payment which is contingent on the success of the research.

(3) ''*On behalf of.*'' Qualified research is performed on behalf of the taxpayer if the taxpayer has a right to the research results. Qualified research can be performed on behalf of the taxpayer notwithstanding the fact that the taxpayer does not have exclusive rights to the results.

(4) *Prepaid amounts.* Notwithstanding paragraph (e)(1) of this section, if any contract research expense paid or incurred during any taxable year is attributable to qualified research to be conducted after the close of such taxable year, the expense so attributable shall be treated for purposes of section 41(b)(1)(B) as paid or incurred during the period during which the qualified research is conducted.

(5) *Examples.* The following examples illustrate provisions contained in paragraphs (e) (1) through (4) of this section.

Example 1. A, a cash-method taxpayer using the calendar year as the taxable year, enters into a contract with B Corporation under which B is to perform qualified research on behalf of A. The contract requires A to pay B $300x, regardless of the success of the research. In 1982, B performs all of the research, and A makes full payment of $300x under the contract. Accordingly, during the taxable year 1982, $195x (65 percent of the payment of $300x) constitutes a contract research expense of A.

Example 2. The facts are the same as in example (1), except that B performs 50 percent of the research in 1983. Of the $195x of contract research expense paid in 1982, paragraph (e)(4) of this section provides that $97.5x (50 percent of $195x) is a contract research expense for 1982 and the remaining $97.5x is contract research expense for 1983.

Example 3. The facts are the same as in example (1), except that instead of calling for a flat payment of $300x, the contract requires A to reimburse B for all expenses plus pay B $100x. B incurs expenses attributable to the research as follows:

Labor	$90x
Supplies	20x
Depreciation on equipment	50x

Overhead	40x
Total	200x

Under this agreement A pays B $300x during 1982. Accordingly, during taxable year 1982, $195x (65 percent of $300x) of the payment constitutes a contract research expense of A.

Example 4. The facts are the same as in example (3), except that A agrees to reimburse B for all expenses and agrees to pay B an additional amount of $100x, but the additional $100x is payable only if the research is successful. The research is successful and A pays B $300x during 1982. Paragraph (e)(2) of this section provides that the contingent portion of the payment is not an expense incurred for the performance of qualified research. Thus, for taxable year 1982, $130x (65 percent of the payment of $200x) constitutes a contract research expense of A.

Example 5. C conducts in-house qualified research in carrying on a trade or business. In addition, C pays D Corporation, a provider of computer services, $100x to develop software to be used in analyzing the results C derives from its research. Because the software services, if performed by an employee of C, would constitute qualified services, $65x of the $100x constitutes a contract research expense of C.

Example 6. C conducts in-house qualified research in carrying on C's trade or business. In addition, C contracts with E Corporation, a provider of temporary secretarial services, for the services of a secretary for a week. The secretary spends the entire week typing reports describing laboratory results derived from C's qualified research. C pays E $400 for the secretarial service, none of which constitutes wages within the meaning of section 41(b)(2)(D). These services, if performed by employees of C, would constitute qualified services within the meaning of section 41(b)(2)(B). Thus, pursuant to paragraph (e)(1) of this section, $260 (65 percent of $400) constitutes a contract research expense of C.

Example 7. C conducts in-house qualified research in carrying on C's trade or business. In addition, C pays F, an outside accountant, $100x to keep C's books and records pertaining to the research project. The activity carried on by the accountant does not constitute qualified research as defined in section 41(d). The services performed by the accountant, if performed by an employee of C, would not constitute qualified services (as defined in section 41(b)(2)(B)). Thus, under paragraph (e)(1) of this section, no portion of the $100x constitutes a contract research expense.

[T.D. 8251, 54 FR 21204, May 17, 1989, as amended by T.D. 8930, 65 FR 287, Jan. 3, 2001]

§ 1.41–3 Base amount for taxable years beginning on or after January 3, 2001.

(a) *New taxpayers.* If, with respect to any credit year, the taxpayer has not been in existence for any previous taxable year, the average annual gross receipts of the taxpayer for the four taxable years preceding the credit year shall be zero. If, with respect to any credit year, the taxpayer has been in existence for at least one previous taxable year, but has not been in existence for four taxable years preceding the taxable year, then the average annual gross receipts of the taxpayer for the four taxable years preceding the credit year shall be the average annual gross receipts for the number of taxable years preceding the credit year for which the taxpayer has been in existence.

(b) *Special rules for short taxable years*—(1) *Short credit year.* If a credit year is a short taxable year, then the base amount determined under section 41(c)(1) (but not section 41(c)(2)) shall be modified by multiplying that amount by the number of months in the short taxable year and dividing the result by 12.

(2) *Short taxable year preceding credit year.* If one or more of the four taxable years preceding the credit year is a short taxable year, then the gross receipts for such year are deemed to be equal to the gross receipts actually derived in that year multiplied by 12 and divided by the number of months in that year.

(3) *Short taxable year in determining fixed-base percentage.* No adjustment shall be made on account of a short taxable year to the computation of a taxpayer's fixed-base percentage.

(c) *Definition of gross receipts*—(1) *In general.* For purposes of section 41, gross receipts means the total amount, as determined under the taxpayer's method of accounting, derived by the taxpayer from all its activities and from all sources (e.g., revenues derived from the sale of inventory before reduction for cost of goods sold).

(2) *Amounts excluded.* For purposes of this paragraph (c), gross receipts do not include amounts representing—

(i) Returns or allowances;

(ii) Receipts from the sale or exchange of capital assets, as defined in section 1221;

(iii) Repayments of loans or similar instruments (e.g., a repayment of the principal amount of a loan held by a commercial lender);

(iv) Receipts from a sale or exchange not in the ordinary course of business, such as the sale of an entire trade or business or the sale of property used in a trade or business as defined under section 1221(2);

(v) Amounts received 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; and

(vi) Amounts received by a taxpayer in a taxable year that precedes the first taxable year in which the taxpayer derives more than $25,000 in gross receipts other than investment income. For purposes of this paragraph (c)(2)(vi), investment income is interest or distributions with respect to stock (other than the stock of a 20-percent owned corporation as defined in section 243(c)(2).

(3) *Foreign corporations.* For purposes of section 41, in the case of a foreign corporation, gross receipts include only gross receipts that are effectively connected with the conduct of a trade or business within the United States, the Commonwealth of Puerto Rico, or other possessions of the United States. See section 864(c) and applicable regulations thereunder for the definition of effectively connected income.

(d) *Consistency requirement*—(1) *In general.* In computing the credit for increasing research activities for taxable years beginning after December 31, 1989, qualified research expenses and gross receipts taken into account in computing a taxpayer's fixed-base percentage and a taxpayer's base amount must be determined on a basis consistent with the definition of qualified research expenses and gross receipts for the credit year, without regard to the law in effect for the taxable years taken into account in computing the fixed-base percentage or the base amount. This consistency requirement applies even if the period for filing a claim for credit or refund has expired for any taxable year taken into account in computing the fixed-base percentage or the base amount.

(2) *Illustrations.* The following examples illustrate the application of the consistency rule of paragraph (d)(1) of this section:

Example 1. (i) X, an accrual method taxpayer using the calendar year as its taxable year, incurs qualified research expenses in 2001. X wants to compute its research credit under section 41 for the tax year ending December 31, 2001. As part of the computation, X must determine its fixed-base percentage, which depends in part on X's qualified research expenses incurred during the fixed-base period, the taxable years beginning after December 31, 1983, and before January 1, 1989.

(ii) During the fixed-base period, X reported the following amounts as qualified research expenses on its Form 6765:

1984	$100x
1985	120x
1986	150x
1987	180x
1988	170x
Total	720x

(iii) For the taxable years ending December 31, 1984, and December 31, 1985, X based the amounts reported as qualified research expenses on the definition of qualified research in effect for those taxable years. The definition of qualified research changed for taxable years beginning after December 31, 1985. If X used the definition of qualified research applicable to its taxable year ending December 31, 2001, the credit year, its qualified research expenses for the taxable years ending December 31, 1984, and December 31, 1985, would be reduced to $ 80x and $ 100x, respectively. Under the consistency rule in section 41(c)(5) and paragraph (d)(1) of this section, to compute the research credit for the tax year ending December 31, 2001, X must reduce its qualified research expenses for 1984 and 1985 to reflect the change in the definition of qualified research for taxable years beginning after December 31, 1985. Thus, X's total qualified research expenses for the fixed-base period (1984–1988) to be used in computing the fixed-base percentage is $80 + 100 + 150 + 180 + 170 = $680x.

Example 2. The facts are the same as in *Example 1*, except that, in computing its qualified research expenses for the taxable year ending December 31, 2001, X claimed that a certain type of expenditure incurred in 2001 was a qualified research expense. X's claim reflected a change in X's position, because X had not previously claimed that similar expenditures were qualified research expenses. The consistency rule requires X to adjust its qualified research expenses in computing the fixed-base percentage to include any similar expenditures not treated as qualified research expenses during the fixed-base period, regardless of whether the period for filing a claim for credit or refund has expired for any year taken into account in computing the fixed-base percentage.

(e) *Effective date*. The rules in paragraphs (c) and (d) of this section are applicable for taxable years beginning on or after the date final regulations are published in the FEDERAL REGISTER.

[T.D. 8930, 66 FR 289, Jan. 3, 2001]

§ 1.41–4 Qualified research for expenditures paid or incurred in taxable years ending on or after December 31, 2003.

(a) *Qualified research*—(1) *General rule*. Research activities related to the development or improvement of a business component constitute qualified research only if the research activities meet all of the requirements of section 41(d)(1) and this section, and are not otherwise excluded under section 41(d)(3)(B) or (d)(4), or this section.

(2) *Requirements of section 41(d)(1)*. Research constitutes qualified research only if it is research—

(i) With respect to which expenditures may be treated as expenses under section 174, see § 1.174–2;

(ii) That is undertaken for the purpose of discovering information that is technological in nature, and the application of which is intended to be useful in the development of a new or improved business component of the taxpayer; and

(iii) Substantially all of the activities of which constitute elements of a process of experimentation that relates to a qualified purpose.

(3) *Undertaken for the purpose of discovering information*—(i) *In general*. For purposes of section 41(d) and this section, research must be undertaken for the purpose of discovering information that is technological in nature. Research is undertaken for the purpose of discovering information if it is intended to eliminate uncertainty concerning the development or improvement of a business component. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the business component, or the appropriate design of the business component.

(ii) *Application of the discovering information requirement*. A determination that research is undertaken for the purpose of discovering information that is technological in nature does not require the taxpayer be seeking to obtain information that exceeds, expands or refines the common knowledge of skilled professionals in the particular field of science or engineering in which the taxpayer is performing the research. In addition, a determination that research is undertaken for the purpose of discovering information that is technological in nature does not require that the taxpayer succeed in developing a new or improved business component.

(iii) *Patent safe harbor*. For purposes of section 41(d) and paragraph (a)(3)(i) of this section, the issuance of a patent by the Patent and Trademark Office under the provisions of 35 U.S.C. 151 (other than a patent for design issued under the provisions of 35 U.S.C. 171) is conclusive evidence that a taxpayer has discovered information that is technological in nature that is intended to eliminate uncertainty concerning the development or improvement of a business component. However, the issuance of such a patent is not a precondition for credit availability.

(4) *Technological in nature*. For purposes of section 41(d) and this section, information is technological in nature if the process of experimentation used to discover such information fundamentally relies on principles of the physical or biological sciences, engineering, or computer science. A taxpayer may employ existing technologies and may rely on existing principles of the physical or biological sciences, engineering, or computer science to satisfy this requirement.

(5) *Process of experimentation*—(i) *In general*. For purposes of section 41(d) and this section, a process of experimentation is a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result,

or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities. A process of experimentation must fundamentally rely on the principles of the physical or biological sciences, engineering, or computer science and involves the identification of uncertainty concerning the development or improvement of a business component, the identification of one or more alternatives intended to eliminate that uncertainty, and the identification and the conduct of a process of evaluating the alternatives (through, for example, modeling, simulation, or a systematic trial and error methodology). A process of experimentation must be an evaluative process and generally should be capable of evaluating more than one alternative. A taxpayer may undertake a process of experimentation if there is no uncertainty concerning the taxpayer's capability or method of achieving the desired result so long as the appropriate design of the desired result is uncertain as of the beginning of the taxpayer's research activities. Uncertainty concerning the development or improvement of the business component (e.g., its appropriate design) does not establish that all activities undertaken to achieve that new or improved business component constitute a process of experimentation.

(ii) *Qualified purpose.* For purposes of section 41(d) and this section, a process of experimentation is undertaken for a qualified purpose if it relates to a new or improved function, performance, reliability or quality of the business component. Research will not be treated as conducted for a qualified purpose if it relates to style, taste, cosmetic, or seasonal design factors.

(6) *Substantially all requirement.* In order for activities to constitute qualified research under section 41(d)(1), substantially all of the activities must constitute elements of a process of experimentation that relates to a qualified purpose. The substantially all requirement of section 41(d)(1)(C) and paragraph (a)(2)(iii) of this section is satisfied only if 80 percent or more of a taxpayer's research activities, measured on a cost or other consistently applied reasonable basis (and without regard to section 1.41–2(d)(2)), constitute elements of a process of experimentation for a purpose described in section 41(d)(3). Accordingly, if 80 percent (or more) of a taxpayer's research activities with respect to a business component constitute elements of a process of experimentation for a purpose described in section 41(d)(3), the substantially all requirement is satisfied even if the remaining 20 percent (or less) of a taxpayer's research activities with respect to the business component do not constitute elements of a process of experimentation for a purpose described in section 41(d)(3), so long as these remaining research activities satisfy the requirements of section 41(d)(1)(A) and are not otherwise excluded under section 41(d)(4). The substantially all requirement is applied separately to each business component.

(7) *Use of computers and information technology.* The employment of computers or information technology, or the reliance on principles of computer science or information technology to store, collect, manipulate, translate, disseminate, produce, distribute, or process data or information, and similar uses of computers and information technology does not itself establish that qualified research has been undertaken.

(8) *Illustrations.* The following examples illustrate the application of paragraph (a)(5) of this section:

Example 1. (i) *Facts.* X is engaged in the business of developing and manufacturing widgets. X wants to change the color of its blue widget to green. X obtains from various suppliers several different shades of green paint. X paints several sample widgets, and surveys X's customers to determine which shade of green X's customers prefer.

(ii) *Conclusion.* X's activities to change the color of its blue widget to green are not qualified research under section 41(d)(1) and paragraph (a)(5) of this section because substantially all of X's activities are not undertaken for a qualified purpose. All of X's research activities are related to style, taste, cosmetic, or seasonal design factors.

Example 2. (i) *Facts.* The facts are the same as in *Example 1,* except that X chooses one of the green paints. X obtains samples of the green paint from a supplier and determines that X must modify its painting process to accommodate the green paint because the green paint has different characteristics from other paints X has used. X obtains detailed data on the green paint from X's paint supplier. X also consults with the manufacturer of X's paint spraying machines. The manufacturer informs X that X must acquire a new nozzle that operates with the green paint X wants to use. X tests the nozzles to ensure that they work as specified by the manufacturer of the paint spraying machines.

(ii) *Conclusion.* X's activities to modify its painting process are a separate business component under section 41(d)(2)(A). X's activities to modify its painting process to change the color of its blue widget to green are not qualified research under section 41(d)(1) and paragraph (a)(5) of this section. X did not conduct a process of evaluating alternatives in order to eliminate uncertainty regarding the modification of its painting process. Rather, the manufacturer of the paint machines eliminated X's uncertainty regarding the modification of its painting process. X's activities to test the nozzles to determine if the nozzles work as specified by the manufacturer of the paint spraying machines are in the nature of routine or ordinary testing or inspection for quality control.

Example 3. (i) *Facts.* X is engaged in the business of manufacturing food products and currently manufactures a large-shred version of a product. X seeks to modify its current production line to permit it to manufacture both a large-shred version and a fine-shred version of one of its food products. A smaller, thinner shredding blade capable of producing a fine-shred version of the food product, however, is not commercially available. Thus, X must develop a new shredding blade that can be fitted onto its current production line. X is uncertain concerning the design of the new shredding blade, because the material used in its existing blade breaks when machined into smaller, thinner blades. X engages in a systematic trial and error process of analyzing various blade designs and materials to determine whether the new shredding blade must be constructed of a different material from that of its existing shredding blade and, if so, what material will best meet X's functional requirements.

(ii) *Conclusion.* X's activities to modify its current production line by developing the new shredding blade meet the requirements of qualified research as set forth in paragraph (a)(2) of this section. Substantially all of X's activities constitute elements of a process of experimentation because X evaluated alternatives to achieve a result where the method of achieving that result, and the appropriate design of that result, were uncertain as of the beginning of the taxpayer's research activities. X identified uncertainties related to the development of a business component, and identified alternatives intended to eliminate these uncertainties. Furthermore, X's process of evaluating identified alternatives was technological in nature, and was undertaken to eliminate the uncertainties.

Example 4. (i) *Facts.* X is in the business of designing, developing and manufacturing automobiles. In response to government-mandated fuel economy requirements, X seeks to update its current model vehicle and undertakes to improve aerodynamics by lowering the hood of its current model vehicle. X determines, however, that lowering the hood changes the air flow under the hood, which changes the rate at which air enters the engine through the air intake system, and which reduces the functionality of the cooling system. X's engineers are uncertain how to design a lower hood to obtain the increased fuel economy, while maintaining the necessary air flow under the hood. X designs, models, simulates, tests, refines, and re-tests several alternative designs for the hood and associated proposed modifications to both the air intake system and cooling system. This process enables X to eliminate the uncertainties related to the integrated design of the hood, air intake system, and cooling system, and such activities constitute eighty-five percent of X's total activities to update its current model vehicle. X then engages in additional activities that do not involve a process of evaluating alternatives in order to eliminate uncertainties. The additional activities constitute only fifteen percent of X's total activities to update its current model vehicle.

(ii) *Conclusion.* In general, if eighty percent or more of a taxpayer's research activities measured on a cost or other consistently applied reasonable basis constitute elements of a process of experimentation for a qualified purpose under section 41(d)(3)(A) and paragraph (a)(5)(ii) of this section, then the substantially all requirement of section 41(d)(1)(C) and paragraph (a)(2)(iii) of this section is satisfied. Substantially all of X's activities constitute elements of a process of experimentation because X evaluated alternatives to achieve a result where the method of achieving that result, and the appropriate design of that result, were uncertain as of the beginning of X's research activities. X identified uncertainties related to the improvement of a business component and identified alternatives intended to eliminate these uncertainties. Furthermore, X's process of evaluating the identified alternatives was technological in nature and was undertaken to eliminate the uncertainties. Because substantially all (in this example, eighty-five percent) of X's activities to update its current model vehicle constitute elements of a process of experimentation for a qualified purpose described in section 41(d)(3)(A), all of X's activities to update its current model vehicle meet the requirements of qualified research as set forth in paragraph (a)(2) of this section, provided that X's remaining activities (in this example, fifteen percent of X's total activities) satisfy the requirements of section 41(d)(1)(A) and are not otherwise excluded under section 41(d)(4).

Example 5. (i) *Facts.* X, a retail and distribution company, wants to upgrade its warehouse management software. X evaluates several of the alternative warehouse management software products available from vendors in the marketplace to determine which product will best serve X's technical requirements. X selects vendor V's software.

(ii) *Conclusion.* X's activities to select the software are not qualified research under section 41(d)(1) and paragraph (a)(5) of this section. X did not conduct a process of evaluating alternatives in order to eliminate uncertainty regarding the development of a business component. X's evaluation of products available from vendors is not a process of experimentation.

Example 6. (i) *Facts.* X wants to develop a new web application to allow customers to purchase its products online. X, after reviewing commercial software offered by various vendors, purchases a commercial software package of object-oriented functions from vendor Z that X can use in its web application (for example, a shopping cart). X evaluates the various object-oriented functions included in vendor Z's software package to determine which functions it can use. X then incorporates the selected software functions in its new web application software.

(ii) *Conclusion.* X's activities related to selecting the commercial software vendor with the object-oriented functions it wanted, and then selecting which functions to use, are not qualified research under section 41(d)(1) and paragraph (a)(5) of this section. In addition, incorporating the selected object-oriented functions into the new web application software being developed by X did not involve conducting a process of evaluating alternatives in order to eliminate uncertainty regarding the development of software. X's evaluation of products available from vendors and selection of software functions are not a process of experimentation.

Example 7. (i) *Facts.* In order to be more responsive to user online requests, X wants to develop software to balance the incoming processing requests across multiple web servers that run the same set of software applications. Without evaluating or testing any alternatives, X decides that a separate server will be used to distribute the workload across each of the web servers and that a round robin workload distribution algorithm is appropriate for its needs.

(ii) *Conclusion.* X's activities to develop the software are activities relating to the development of a separate business component under section 41(d)(2)(A). X's activities to develop the load distribution function are not qualified research under section 41(d)(1) and paragraph (a)(5) of this section. X did not conduct a process of evaluating different load distribution alternatives in order to eliminate uncertainty regarding the development of software. X's selection of a separate server and a round robin distribution algorithm is not a process of experimentation.

Example 8. (i) *Facts.* X must develop load balancing software across a server cluster supporting multiple web applications. X's web applications have high concurrency demands because of a dynamic, highly volatile environment. X is uncertain of the appropriate design of the load balancing algorithm, given that the existing evolutionary algorithms did not meet the demands of their highly volatile web environment. Therefore, X designs and systematically tests and evaluates several different algorithms that perform the load distribution functions.

(ii) *Conclusion.* X's activities to develop software are activities to develop a separate business component under section 41(d)(2)(A). X's activities involving the design, evaluation, and systematic testing of several new load balancing algorithms meet the requirements as set forth in paragraph (a)(5) of this section. X's activities constitute elements of a process of experimentation because X identified uncertainties related to the development of a business component, identified alternatives intended to eliminate those uncertainties, and evaluated one or more alternatives to achieve a result where the appropriate design was uncertain at the beginning of X's research activities.

Example 9. (i) *Facts.* X, a multinational manufacturer, wants to install an enterprise resource planning (ERP) system that runs off a single database so that X can track orders more easily, and coordinate manufacturing, inventory, and shipping among many different locations at the same time. In order to successfully install and implement ERP software, X evaluates its business needs and the technical requirements of the software, such as processing power, memory, storage, and network resources. X devotes the majority of its resources in implementing the ERP system to evaluating the available templates, reports, and other standard programs and choosing among these alternatives in configuring the system to match its business process and reengineering its business process to match the available alternatives in the ERP system. X also performs some data transfer from its old system, involving routine programming and one-to-one mapping of data to be exchanged between each system.

(ii) *Conclusion.* X's activities related to the ERP software including the data transfer are not qualified research under section 41(d)(1) and paragraph (a)(5) of this section. X did not conduct a process of evaluating alternatives in order to eliminate uncertainty regarding the development of software. X's activities in choosing between available templates, reports, and other standard programs and conducting data transfer are not elements of a process of experimentation.

Example 10. (i) *Facts.* Same facts as *Example 9* except that X determines that it must interface part of its legacy software with the new ERP software because the ERP software does not provide a particular function that X requires for its business. As a result, X must develop an interface between its legacy software and the ERP software, and X evaluates several data exchange software applications and chooses one of the available alternatives. X is uncertain as to how to keep the data synchronized between the legacy and ERP systems. Thus, X engages in systematic trial and error testing of several newly designed data caching algorithms to eliminate synchronization problems.

(ii) *Conclusion.* Substantially all of X's activities with respect to this ERP project do not satisfy the requirements for a process of experimentation. However, when the shrinking-back rule is applied, a subset of X's activities do satisfy the requirements for a process of experimentation. X's activities to develop the data caching software and keeping the data on the legacy and ERP systems synchronized meet the requirements of qualified research as set forth in paragraph (a)(2) of this section. Substantially all of X's activities to develop the specialized data caching and synchronization software constitute elements of a process of experimentation because X identified uncertainties related to the development of a business component, identified alternatives intended to eliminate those uncertainties, and evaluated alternatives to achieve a result where the appropriate design of that result was uncertain as of the beginning of the taxpayer's research activities.

(b) *Application of requirements for qualified research*—(1) *In general.* The requirements for qualified research in section 41(d)(1) and paragraph (a) of this section, must be applied separately to each business component, as defined in section 41(d)(2)(B). In cases involving development of both a product and a manufacturing or other commercial production process for the product, research activities relating to development of the process are not qualified research unless the requirements of section 41(d) and this section are met for the research activities relating to the process without taking into account the research activities relating to development of the product. Similarly, research activities relating to development of the product are not qualified research unless the requirements of section 41(d) and this section are met for the research activities relating to the product without taking into account the research activities relating to development of the manufacturing or other commercial production process.

(2) *Shrinking-back rule.* The requirements of section 41(d) and paragraph (a) of this section are to be applied first at the level of the discrete business component, that is, the product, process, computer software, technique, formula, or invention to be held for sale, lease, or license, or used by the taxpayer in a trade or business of the taxpayer. If these requirements are not met at that level, then they apply at the most significant subset of elements of the product, process, computer software, technique, formula, or invention to be held for sale, lease, or license. This shrinking back of the product is to continue until either a subset of elements of the product that satisfies the requirements is reached, or the most basic element of the product is reached and such element fails to satisfy the test. This shrinking-back rule is applied only if a taxpayer does not satisfy the requirements of section 41(d)(1) and paragraph (a)(2) of this section with respect to the overall business component. The shrinking-back rule is not itself applied as a reason to exclude research activities from credit eligibility.

(3) *Illustration.* The following example illustrates the application of this paragraph (b):

Example. X, a motorcycle engine builder, develops a new carburetor for use in a motorcycle engine. X also modifies an existing engine design for use with the new carburetor. Under the shrinking-back rule, the requirements of section 41(d)(1) and paragraph (a) of this section are applied first to the engine. If the modifications to the engine when viewed as a whole, including the development of the new carburetor, do not satisfy the requirements of section 41(d)(1) and paragraph (a) of this section, those requirements are applied to the next most significant subset of elements of the business component. Assuming that the next most significant subset of elements of the engine is the carburetor, the research activities in developing the new carburetor may constitute qualified research within the meaning of section 41(d)(1) and paragraph (a) of this section.

(c) *Excluded activities*—(1) *In general.* Qualified research does not include any activity described in section 41(d)(4) and paragraph (c) of this section.

(2) *Research after commercial production*—(i) *In general.* Activities conducted after the beginning of commercial production of a business component are not qualified research. Activities are conducted after the beginning of commercial production of a business component if such activities are conducted after the component is developed to the point where it is ready for commercial sale or use, or meets the basic functional and economic requirements of the taxpayer for the component's sale or use.

(ii) *Certain additional activities related to the business component.* The following activities are deemed to occur after the beginning of commercial production of a business component—

(A) Preproduction planning for a finished business component;

(B) Tooling-up for production;

(C) Trial production runs;

(D) Trouble shooting involving detecting faults in production equipment or processes;

(E) Accumulating data relating to production processes; and

(F) Debugging flaws in a business component.

(iii) *Activities related to production process or technique.* In cases involving development of both a product and a manufacturing or other commercial production process for the product, the exclusion described in section 41(d)(4)(A) and paragraphs (c)(2)(i) and (ii) of this section applies separately for the activities relating to the development of the product and the activities relating to the development of the process. For example, even after a product meets the taxpayer's basic functional and economic requirements, activities relating to the development of the manufacturing process still may constitute qualified research, provided that the development of the process itself separately satisfies the requirements of section 41(d) and this section, and the activities are conducted before the process meets the taxpayer's basic functional and economic requirements or is ready for commercial use.

(iv) *Clinical testing.* Clinical testing of a pharmaceutical product prior to its commercial production in the United States is not treated as occurring after the beginning of commercial production even if the product is commercially available in other countries. Additional clinical testing of a pharmaceutical product after a product has been approved for a specific therapeutic use by the Food and Drug Administration and is ready for commercial production and sale is not treated as occurring after the beginning of commercial production if such clinical testing is undertaken to establish new functional uses, characteristics, indications, combinations, dosages, or delivery forms for the product. A functional use, characteristic, indication, combination, dosage, or delivery form shall be considered new only if such functional use, characteristic, indication, combination, dosage, or delivery form must be approved by the Food and Drug Administration.

(3) *Adaptation of existing business components.* Activities relating to adapting an existing business component to a particular customer's requirement or need are not qualified research. This exclusion does not apply merely because a business component is intended for a specific customer.

(4) *Duplication of existing business component.* Activities relating to reproducing an existing business component (in whole or in part) from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information about the business component are not qualified research. This exclusion does not apply merely because the taxpayer examines an existing business component in the course of developing its own business component.

(5) *Surveys, studies, research relating to management functions, etc.* Qualified research does not include activities relating to—

(i) Efficiency surveys;

(ii) Management functions or techniques, including such items as preparation of financial data and analysis, development of employee training programs and management organization plans, and management-based changes in production processes (such as rearranging work stations on an assembly line);

(iii) Market research, testing, or development (including advertising or promotions);

(iv) Routine data collections; or

(v) Routine or ordinary testing or inspections for quality control.

(6) *Internal use software*—(i) *General rule*. Research with respect to software that is developed by (or for the benefit of) the taxpayer primarily for the taxpayer's internal use is eligible for the research credit only if—

(A) The research with respect to the software satisfies the requirements of section 41(d)(1);

(B) The research with respect to the software is not otherwise excluded under section 41(d)(4) (other than section 41(d)(4)(E)); and

(C) The software satisfies the high threshold of innovation test of paragraph (c)(6)(vii) of this section.

(ii) *Inapplicability of the high threshold of innovation test*. This paragraph (c)(6) does not apply to the following:

(A) Software developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer for use in an activity that constitutes qualified research (other than the development of the internal use software itself);

(B) Software developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer for use in a production process to which the requirements of section 41(d)(1) are met; and

(C) A new or improved package of software and hardware developed together by the taxpayer as a single product (or to the costs to modify an acquired software and hardware package), of which the software is an integral part, that is used directly by the taxpayer in providing services in its trade or business. In these cases, eligibility for the research credit is to be determined by examining the combined hardware-software product as a single product.

(iii) *Software developed primarily for internal use*—(A) *In general*. Except as otherwise provided in paragraph (c)(6)(vi) of this section, software is developed by (or for the benefit of) the taxpayer primarily for the taxpayer's internal use if the software is developed for use in general and administrative functions that facilitate or support the conduct of the taxpayer's trade or business. Software that the taxpayer develops primarily for a related party's internal use will be considered internal use software. A related party is any corporation, trade or business, or other person that is treated as a single taxpayer with the taxpayer pursuant to section 41(f).

(B) *General and administrative functions*. General and administrative functions are:

(*1*) *Financial management*. Financial management functions are functions that involve the financial management of the taxpayer and the supporting recordkeeping. Financial management functions include, but are not limited to, functions such as accounts payable, accounts receivable, inventory management, budgeting, cash management, cost accounting, disbursements, economic analysis and forecasting, financial reporting, finance, fixed asset accounting, general ledger bookkeeping, internal audit, management accounting, risk management, strategic business planning, and tax.

(*2*) *Human resources management*. Human resources management functions are functions that manage the taxpayer's workforce. Human resources management functions include, but are not limited to, functions such as recruiting, hiring, training, assigning personnel, and maintaining personnel records, payroll, and benefits.

(*3*) *Support services*. Support services are other functions that support the day- to-day operations of the taxpayer. Support services include, but are not limited to, functions such as data processing, facility services (for example, grounds keeping, housekeeping, janitorial, and logistics), graphic services, marketing, legal services, government compliance services, printing and publication services, and security services (for example, video surveillance and physical asset protection from fire and theft).

(iv) *Software not developed primarily for internal use.* Software is not developed primarily for the taxpayer's internal use if it is not developed for use in general and administrative functions that facilitate or support the conduct of the taxpayer's trade or business, such as—

(A) Software developed to be commercially sold, leased, licensed, or otherwise marketed to third parties; or

(B) Software developed to enable a taxpayer to interact with third parties or to allow third parties to initiate functions or review data on the taxpayer's system.

(v) *Time and manner of determination.* For purposes of paragraphs (c)(6)(iii) and (iv) of this section, whether software is developed primarily for internal use or not developed primarily for internal use depends on the intent of the taxpayer and the facts and circumstances at the beginning of the software development. For example, software will not be considered internal use software solely because it is used internally for purposes of testing prior to commercial sale, lease, or license. If a taxpayer originally develops software primarily for internal use, but later makes improvements to the software with the intent to hold the improved software to be sold, leased, licensed, or otherwise marketed to third parties, or to interact with third parties or to allow third parties to initiate functions or review data on the taxpayer's system using the improved software, the improvements will be considered separate from the existing software and will not be considered developed primarily for internal use. Alternatively, if a taxpayer originally develops software to be sold, leased, licensed, or otherwise marketed to third parties, or to interact with third parties or to allow third parties to initiate functions or review data on the taxpayer's system, but later makes improvements to the software with the intent to use the software in general and administrative functions, the improvements will be considered separate from the existing software and will be considered developed primarily for internal use.

(vi) *Software developed for both internal use and to enable interaction with third parties (dual function software)*—(A) *Presumption of development primarily for internal use.* Unless paragraph (c)(6)(vi)(B) or (C) of this section applies, software developed by (or for the benefit of) the taxpayer both for use in general and administrative functions that facilitate or support the conduct of the taxpayer's trade or business and to enable a taxpayer to interact with third parties or to allow third parties to initiate functions or review data on the taxpayer's system (dual function software) is presumed to be developed primarily for a taxpayer's internal use.

(B) *Identification of a subset of elements of software that only enables interaction with third parties.* To the extent that a taxpayer can identify a subset of elements of dual function software that only enables a taxpayer to interact with third parties or allows third parties to initiate functions or review data (third party subset), the presumption under paragraph (c)(6)(vi)(A) of this section does not apply to such third party subset, and such third party subset is not developed primarily for internal use as described under paragraph (c)(6)(iv)(B) of this section.

(C) *Safe harbor for expenditures related to software developed for both internal use and to enable interaction with third parties.* If, after the application of paragraph (c)(6)(vi)(B) of this section, there remains dual function software or a subset of elements of dual function software (dual function subset), a taxpayer may include 25 percent of the qualified research expenditures of such dual function software or dual function subset in computing the amount of the taxpayer's credit. This paragraph (c)(6)(vi)(C) applies only if the taxpayer's research activities related to the development or improvement of the dual function software or dual function subset constitute qualified research under section 41(d), without regard to section 41(d)(4)(E), and the dual function software or dual function subset's use by third parties or by the taxpayer to interact with third parties is reasonably anticipated to constitute at least 10 percent of the dual function software or the dual function subset's use. An objective, reasonable method within the taxpayer's industry must be used to estimate the dual function software or dual function subset's use by third parties or by the taxpayer to interact with third parties. An objective, reasonable method may include, but is not limited to, processing time, amount of data transfer, and number of software user interface screens.

(D) *Time and manner of determination.* A taxpayer must apply this paragraph (c)(6)(vi) based on the intent of the taxpayer and the facts and circumstances at the beginning of the software development.

(E) *Third party.* For purposes of paragraphs (c)(6)(iv), (v), and (vi) of this section, the term *third party* means any corporation, trade or business, or other person that is not treated as a single taxpayer with the taxpayer pursuant to section 41(f). Additionally, for purposes of paragraph (c)(6)(iv)(B) of this section, third parties do not include any persons that use the software to support the general and administrative functions of the taxpayer.

(vii) *High threshold of innovation test*—(A) *In general.* Software satisfies this paragraph (c)(6)(vii) only if the taxpayer can establish that—

(*1*) The software is innovative;

(*2*) The software development involves significant economic risk; and

(*3*) The software is not commercially available for use by the taxpayer in that the software cannot be purchased, leased, or licensed and used for the intended purpose without modifications that would satisfy the requirements of paragraphs (c)(6)(vii)(A)(*1*) and (*2*) of this section.

(B) *Innovative.* Software is innovative if the software would result in a reduction in cost or improvement in speed or other measurable improvement, that is substantial and economically significant, if the development is or would have been successful. This is a measurable objective standard, not a determination of the unique or novel nature of the software or the software development process.

(C) *Significant economic risk.* The software development involves significant economic risk if the taxpayer commits substantial resources to the development and if there is substantial uncertainty, because of technical risk, that such resources would be recovered within a reasonable period. The term ''substantial uncertainty'' requires a higher level of uncertainty and technical risk than that required for business components that are not internal use software. This standard does not require technical uncertainty regarding whether the final result can ever be achieved, but rather whether the final result can be achieved within a timeframe that will allow the substantial resources committed to the development to be recovered within a reasonable period. Technical risk arises from uncertainty that is technological in nature, as defined in paragraph (a)(4) of this section, and substantial uncertainty must exist at the beginning of the taxpayer's activities.

(D) *Application of high threshold of innovation test.* The high threshold of innovation test of paragraph (c)(6)(vii) of this section takes into account only the results anticipated to be attributable to the development of new or improved software at the beginning of the software development independent of the effect of any modifications to related hardware or other software. The implementation of existing technology by itself is not evidence of innovation, but the use of existing technology in new ways could be evidence of a high threshold of innovation if it resolves substantial uncertainty as defined in paragraph (c)(6)(vii)(C) of this section.

(viii) *Illustrations.* The following examples illustrate provisions contained in this paragraph (c)(6). No inference should be drawn from these examples concerning the application of section 41(d)(1) and paragraph (a) of this section to these facts.

Example 1. Computer hardware and software developed as a single product—(i) *Facts.* X is a telecommunications company that developed high technology telephone switching hardware. In addition, X developed software that interfaces directly with the hardware to initiate and terminate a call, along with other functions. X designed and developed the hardware and software together.

(ii) *Conclusion.* The telecommunications software that interfaces directly with the hardware is part of a package of software and hardware developed together by the taxpayer that is used by the taxpayer in providing services in its trade or business. Accordingly, this paragraph (c)(6) does not apply to the software that interfaces directly with the hardware as described in paragraph (c)(6)(ii)(C) of this section, and eligibility for the research credit is determined by examining the combined software-hardware product as a single product.

Example 2. Internal use software; financial management—(i) *Facts.* X, a manufacturer, self-insures its liabilities for employee health benefits. X develops its own software to administer its self-insurance reserves related to employee health benefits. At the beginning of the development, X does not intend to develop the software for commercial sale, lease, license, or to be otherwise marketed to third parties or to enable X to interact with third parties or to allow third parties to initiate functions or review data on X's system.

(ii) *Conclusion.* The software is developed for use in a general and administrative function because reserve valuation is a financial management function under paragraph (c)(6)(iii)(B)(*1*) of this section. Accordingly, the software is internal use software because it is developed for use in a general and administrative function.

Example 3. Internal use software; human resources management—(i) *Facts.* X, a manufacturer, develops a software module that interacts with X's existing payroll software to allow X's employees to print pay stubs and make certain changes related to payroll deductions over the internet. At the beginning of the development, X does not intend to develop the software module for commercial sale, lease, license, or to be otherwise marketed to third parties or to enable X to interact with third parties or to allow third parties to initiate functions or review data on X's system.

(ii) *Conclusion.* The employee access software module is developed for use in a general and administrative function because employee access software is a human resources management function under paragraph (c)(6)(iii)(B)(*2*) of this section. Accordingly, the software module is internal use software because it is developed for use in a general and administrative function.

Example 4. Internal use software; support services—(i) *Facts.* X, a restaurant, develops software for a Web site that provides information, such as items served, price, location, phone number, and hours of operation for purposes of advertising. At the beginning of the development, X does not intend to develop the Web site software for commercial sale, lease, license, or to be otherwise marketed to third parties or to enable X to interact with third parties or to allow third parties to initiate functions or review data on X's system. X intends to use the software for marketing by allowing third parties to review general information on X's Web site.

(ii) *Conclusion.* The software is developed for use in a general and administrative function because the software was developed to be used by X for marketing which is a support services function under paragraph (c)(6)(iii)(B)(*3*) of this section. Accordingly, the software is internal use software because it is developed for use in a general and administrative function.

Example 5. Internal use software—(i) *Facts.* X, a multinational manufacturer with different business and financial systems in each of its divisions, undertakes a software development project aimed at integrating the majority of the functional areas of its major software systems (Existing Software) into a single enterprise resource management system supporting centralized financial systems, human resources, inventory, and sales. X purchases software (New Software) upon which to base its enterprise-wide system. X has to develop software (Developed Software) that transfers data from X's legacy financial, human resources, inventory, and sales systems to the New Software. At the beginning of the development, X does not intend to develop the software for commercial sale, lease, license, or to be otherwise marketed to third parties or to enable X to interact with third parties or to allow third parties to initiate functions or review data on X's system.

(ii) *Conclusion.* The financial systems, human resource systems, inventory and sales systems are general and administrative functions under paragraph (c)(6)(iii)(B) of this section. Accordingly, the Developed Software is internal use software because it is developed for use in general and administrative functions.

Example 6. Internal use software; definition of third party—(i) *Facts.* X develops software to interact electronically with its vendors to improve X's inventory management. X develops the software to enable X to interact with vendors and to allow vendors to initiate functions or review data on the taxpayer's system. X defines the electronic messages that will be exchanged between X and the vendors. X's software allows a vendor to request X's current inventory of the vendor's product, and allows a vendor to send a message to X which informs X that the vendor has just made a new shipment of the vendor's product to replenish X's inventory. At the beginning of development, X does not intend to develop the software for commercial sale, lease, license, or to be otherwise marketed to third parties.

(ii) *Conclusion.* Under paragraph (c)(6)(vi)(E) of this section, X's vendors are not third parties for purposes of paragraph (c)(6)(iv) of this section. While X's software was developed to allow vendors to initiate functions or review data on the taxpayer's system, the software is not excluded from internal use software as set forth in paragraph (c)(6)(iv)(B) of this section because the software was developed to allow vendors to use the software to support X's inventory management, which is a general and administrative function of X.

Example 7. Not internal use software; third party interaction—(i) *Facts.* X, a manufacturer of various products, develops software for a Web site with the intent to allow third parties to access data on X's database, to order X's products and track the status of their orders online. At the beginning of the development, X does not intend to develop the Web site software for commercial sale, lease, license, or to be otherwise marketed to third parties.

(ii) *Conclusion.* The software is not developed primarily for internal use because it is not developed for use in a general and administrative function. X developed the software to allow third parties to initiate functions or review data on the taxpayer's system as provided under paragraph (c)(6)(iv)(B) of this section.

Example 8. Not internal use software; third party interaction—(i) *Facts.* X developed software that allows its users to upload and modify photographs at no charge. X earns revenue by selling advertisements that are displayed while users enjoy the software that X offers for free. X also developed software that has interfaces through which advertisers can bid for the best position in placing their ads, set prices for the ads, or develop advertisement campaign budgets. At the beginning of the development, X intended to develop the software to enable X to interact with third parties or to allow third parties to initiate functions on X's system.

(ii) *Conclusion.* The software for uploading and modifying photographs is not developed primarily for internal use because it is not developed for use in X's general and administrative functions under paragraph (c)(6)(iii)(A) of this section. The users and the advertisers are third parties for purposes of paragraph (c)(6)(iv) of this section. Furthermore, both the software for uploading and modifying photographs and the advertising software are not internal use software under paragraph (c)(6)(iv)(B) of this section because at the beginning of the development X developed the software with the intention of enabling X to interact with third parties or to allow third parties to initiate functions on X's system.

Example 9. Not internal use software; commercially sold, leased, licensed, or otherwise marketed—(i) *Facts.* X is a provider of cloud-based software. X develops enterprise application software (including customer relationship management, sales automation, and accounting software) to be accessed online and used by X's customers. At the beginning of development, X intended to develop the software for commercial sale, lease, license, or to be otherwise marketed to third parties.

(ii) *Conclusion.* The software is not developed primarily for internal use because it is not developed for use in a general and administrative function. X developed the software to be commercially sold, leased, licensed, or otherwise marketed to third parties under paragraph (c)(6)(iv)(A) of this section.

Example 10. Improvements to existing internal use software—(i) *Facts.* X has branches throughout the country and develops its own facilities services software to coordinate moves and to track maintenance requests for all locations. At the beginning of the development, X does not intend to develop the software for commercial sale, lease, license, or to be otherwise marketed to third parties or to enable X to interact with third parties or to allow third parties to initiate functions or review data on X's system. Several years after completing the development and using the software, X consults its business development department, which assesses the market for the software. X determines that the software could be sold at a profit if certain technical and functional enhancements are made. X develops the improvements to the software, and sells the improved software to third parties.

(ii) *Conclusion.* Support services, which include facility services, are general and administrative functions under paragraph (c)(6)(iii)(B) of this section. Accordingly, the original software is developed for use in general and administrative functions and is, therefore, developed primarily for internal use. However, the improvements to the software are not developed primarily for internal use because the improved software was not developed for use in a general and administrative function. X developed the improved software to be commercially sold, leased, licensed, or otherwise marketed to third parties under paragraphs (c)(6)(iv)(A) and (c)(6)(v) of this section.

Example 11. Dual function software; identification of a third party subset—(i) *Facts.* X develops software for use in general and administrative functions that facilitate or support the conduct of X's trade or business and to allow third parties to initiate functions. X is able to identify a third party subset. X incurs $50,000 of research expenditures for the software, 50% of which is allocable to the third party subset.

(ii) *Conclusion.* The software developed by X is dual function software. Because X is able to identify a third party subset, the third party subset is not presumed to be internal use software under paragraph (c)(6)(vi)(A) of this section. If X's research activities related to the third party subset constitute qualified research under section 41(d), and the allocable expenditures are qualified research expenditures under section 41(b), $25,000 of the software research expenditures allocable to the third party subset may be included in computing the amount of X's credit, pursuant to paragraph (c)(6)(vi)(B) of this section. If, after the application of paragraph (c)(6)(vi)(B) of this section, there remains a dual function subset, X may determine whether paragraph (c)(6)(vi)(C) of this section applies.

Example 12. Dual function software; application of the safe harbor—(i) *Facts*. The facts are the same as in *Example 11*, except that X is unable to identify a third party subset. X uses an objective, reasonable method at the beginning of the software development to determine that the dual function software's use by third parties to initiate functions is reasonably anticipated to constitute 15% of the dual function software's use.

(ii) *Conclusion*. The software developed by X is dual function software. The software is presumed to be developed primarily for internal use under paragraph (c)(6)(vi)(A) of this section. Although X is unable to identify a third party subset, X reasonably anticipates that the dual function software's use by third parties will be at least 10% of the dual function software's use. If X's research activities related to the development or improvement of the dual function software constitute qualified research under section 41(d), without regard to section 41(d)(4)(E), and the allocable expenditures are qualified research expenditures under section 41(b), X may include $12,500 (25% of $50,000) of the software research expenditures of the dual function software in computing the amount of X's credit pursuant to paragraph (c)(6)(vi)(C) of this section.

Example 13. Dual function software; safe harbor inapplicable—(i) *Facts*. The facts are the same as in *Example 11*, except X is unable to identify a third party subset. X uses an objective, reasonable method at the beginning of the software development to determine that the dual function software's use by third parties to initiate functions is reasonably anticipated to constitute 5% of the dual function software's use.

(ii) *Conclusion*. The software developed by X is dual function software. The software is presumed to be developed primarily for X's internal use under paragraph (c)(6)(vi)(A) of this section. X is unable to identify a third party subset, and X reasonably anticipates that the dual function software's use by third parties will be less than 10% of the dual function software's use. X may only include the software research expenditures of the dual function software in computing the amount of X's credit if the software satisfies the high threshold of innovation test of paragraph (c)(6)(vii) of this section and X's research activities related to the development or improvement of the dual function software constitute qualified research under section 41(d), without regard to section 41(d)(4)(E), and the allocable expenditures are qualified research expenditures under section 41(b).

Example 14. Dual function software; identification of a third party subset and the safe harbor—(i) *Facts*. X develops software for use in general and administrative functions that facilitate or support the conduct of X's trade or business and to allow third parties to initiate functions and review data. X is able to identify a third party subset (Subset A). The remaining dual function subset of the software (Subset B) allows third parties to review data and provides X with data used in its general and administrative functions. X is unable to identify a third party subset of Subset B. X incurs $50,000 of research expenditures for the software, 50% of which is allocable to Subset A and 50% of which is allocable to Subset B. X determines, at the beginning of the software development, that the processing time of the third party use of Subset B is reasonably anticipated to account for 15% of the total processing time of Subset B.

(ii) *Conclusion*. The software developed by X is dual function software. Because X is able to identify a third party subset, such third party subset (Subset A) is not presumed to be internal use software under paragraph (c)(6)(vi)(A) of this section. If X's research activities related to the development or improvement of Subset A constitute qualified research under section 41(d), and the allocable expenditures are qualified research expenditures under section 41(b), the $25,000 of the software research expenditures allocable to Subset A may be included in computing the amount of X's credit pursuant to paragraph (c)(6)(vi)(B) of this section. Although X is unable to identify a third party subset of Subset B, 15% of Subset B's use is reasonably anticipated to be attributable to the use of Subset B by third parties. If X's research activities related to the development or improvement of Subset B constitute qualified research under section 41(d), without regard to section 41(d)(4)(E), and the allocable expenditures are qualified research expenditures under section 41(b), X may include $6,250 (25% × $25,000) of the software research expenditures of Subset B in computing the amount of X's credit, pursuant to paragraph (c)(6)(vi)(C) of this section.

Example 15. Internal use software; application of the high threshold of innovation test—(i) *Facts*. X maintained separate software applications for tracking a variety of human resource (HR) functions, including employee reviews, salary information, location within the hierarchy and physical location of employees, 401(k) plans, and insurance coverage information. X determined that improved HR efficiency could be achieved by redesigning its disparate software applications into one employee-centric system, and worked to develop that system. X also determined that commercially available database management systems did not meet all of the requirements of the proposed system. Rather than waiting several years for vendor offerings to mature and become viable for its purpose, X embarked upon the project utilizing older technology that was severely challenged with respect to data modeling capabilities. The improvements, if successful, would provide a reduction in cost and improvement in speed that is substantial and economically significant. For example, having one employee-centric system would remove the duplicative time and cost of manually entering basic employee information separately in each application because the information would only have to be entered once to be available across all applications. The limitations of the technology X was attempting to utilize required that X attempt to develop a new database architecture. X committed substantial resources to the project, but could not predict, because of technical risk, whether it could develop the database software in the timeframe necessary so that X could recover its resources in a reasonable period. Specifically, X was uncertain regarding the capability of developing, within a reasonable period, a new database architecture using the old technology that would resolve its technological issues regarding the data modeling capabilities and the integration of the disparate systems into one system. At the beginning of the development, X did not intend to develop the software for commercial sale, lease, license, or to be otherwise marketed to third parties or to enable X to interact with third parties or to allow third parties to initiate functions or review data on X's system.

(ii) *Conclusion.* The software is internal use software because it is developed for use in a general and administrative function. However, the software satisfies the high threshold of innovation test set forth in paragraph (c)(6)(vii) of this section. The software was intended to be innovative in that it would provide a reduction in cost or improvement in speed that is substantial and economically significant. In addition, X's development activities involved significant economic risk in that X committed substantial resources to the development and there was substantial uncertainty, because of technical risk, that the resources would be recovered within a reasonable period. Finally, at the time X undertook the development of the system, software meeting X's requirements was not commercially available for use by X.

Example 16. Internal use software; application of the high threshold of innovation test—(i) *Facts.* X undertook a software project to rewrite a legacy mainframe application using an object-oriented programming language, and to move the new application off the mainframe to a client/server environment. Both the object-oriented language and client/server technologies were new to X. This project was undertaken to develop a more maintainable application, which X expected would significantly reduce the cost of maintenance, and implement new features more quickly, which X expected would provide both significant improvements in speed and reduction in cost. Thus, the improvements, if successful, would provide a reduction in cost and improvement in speed that is substantial and economically significant. X also determined that commercially available systems did not meet the requirements of the proposed system. X was certain that it would be able to overcome any technological uncertainties and implement the improvements within a reasonable period. However, X was unsure of the appropriate methodology to achieve the improvements. At the beginning of the development, X does not intend to develop the software for commercial sale, lease, license, or to be otherwise marketed to third parties or to enable X to interact with third parties or to allow third parties to initiate functions or review data on X's system.

(ii) *Conclusion.* The software is internal use software because it is developed for use in a general and administrative function. X's activities do not satisfy the high threshold of innovation test of paragraph (c)(6)(vii) of this section. Although the software meets the requirements of paragraphs (c)(6)(vii)(A)(*1*) and (*3*) of this section, X's development activities did not involve significant economic risk under paragraph (c)(6)(vii)(A)(*2*) of this section. X did not have substantial uncertainty, because of technical risk, that the resources committed to the project would be recovered within a reasonable period.

Example 17. Internal use software; application of the high threshold of innovation test—(i) *Facts.* X wants to expand its internal computing power, and is aware that its PCs and workstations are idle at night, on the weekends, and for a significant part of any business day. Because the general and administrative computations that X needs to make could be done on workstations as well as PCs, X develops a screen-saver-like application that runs on employee computers. When employees' computers have been idle for an amount of time set by each employee, X's application goes back to a central server to get a new job to execute. This job will execute on the idle employee's computer until it has either finished, or the employee resumes working on his computer. The ability to use the idle employees' computers would save X significant costs because X would not have to buy new hardware to expand the computing power. The improvements, if successful, would provide a reduction in cost that is substantial and economically significant. At the time X undertook the software development project, there was no commercial application available with such a capability. In addition, at the time X undertook the software development project, X was uncertain regarding the capability of developing a server application that could schedule and distribute the jobs across thousands of PCs and workstations, as well as handle all the error conditions that occur on a user's machine. X commits substantial resources to the project. X undertakes a process of experimentation to attempt to eliminate its uncertainty. At the beginning of the development, X does not intend to develop the software for commercial sale, lease, license, or to be otherwise marketed to third parties or to enable X to interact with third parties or to allow third parties to initiate functions or review data on X's system.

(ii) *Conclusion.* The software is internal use software because it is developed for use in a general and administrative function. However, the software satisfies the high threshold of innovation test as set forth in paragraph (c)(6)(vii) of this section. The software was intended to be innovative because it would provide a reduction in cost or improvement in speed that is substantial and economically significant. In addition, X's development activities involved significant economic risk in that X committed substantial resources to the development and there was substantial uncertainty that because of technical risk, such resources would be recovered within a reasonable period. Finally, at the time X undertook the development of the system, software meeting X's requirements was not commercially available for use by X.

Example 18. Internal use software; application of the high threshold of innovation test—(i) *Facts.* X, a multinational manufacturer, wants to install an enterprise resource planning (ERP) system that runs off a single database. However, to implement the ERP system, X determines that it must integrate part of its old system with the new because the ERP system does not have a particular function that X requires for its business. The two systems are general and administrative software systems. The systems have mutual incompatibilities. The integration, if successful, would provide a reduction in cost and improvement in speed that is substantial and economically significant. At the time X undertook this project, there was no commercial application available with such a capability. X is uncertain regarding the appropriate design of the interface software. However, X knows that given a reasonable period of time to experiment with various designs, X would be able to determine the appropriate design necessary to meet X's technical requirements and would recover the substantial resources that X commits to the development of the system within a reasonable period. At the beginning of the development, X does not intend to develop the software for commercial sale, lease, license, or to be otherwise marketed to third parties or to enable X to interact with third parties or to allow third parties to initiate functions or review data on X's system.

(ii) *Conclusion.* The software is internal use software because it is developed for use in a general and administrative function. X's activities do not satisfy the high threshold of innovation test of paragraph (c)(6)(vii) of this section. Although the software meets the requirements of paragraphs (c)(6)(vii)(A)(*1*) and (*3*) of this section, X's development activities did not involve significant economic risk under paragraph (c)(6)(vii)(A)(*2*) of this section. X did not have substantial uncertainty, because of technical risk, that the resources committed to the project would be recovered within a reasonable period.

(7) *Activities outside the United States, Puerto Rico, and other possessions*—(i) *In general.* Research conducted outside the United States, as defined in section 7701(a)(9), the Commonwealth of Puerto Rico and other possessions of the United States does not constitute qualified research.

(ii) *Apportionment of in-house research expenses.* In-house research expenses paid or incurred for qualified services performed both in the United States, the Commonwealth of Puerto Rico and other possessions of the United States and outside the United States, the Commonwealth of Puerto Rico and other possessions of the United States must be apportioned between the services performed in the United States, the Commonwealth of Puerto Rico and other possessions of the United States and the services performed outside the United States, the Commonwealth of Puerto Rico and other possessions of the United States. Only those in-house research expenses apportioned to the services performed within the United States, the Commonwealth of Puerto Rico and other possessions of the United States are eligible to be treated as qualified research expenses, unless the in-house research expenses are wages and the 80 percent rule of § 1.41–2(d)(2) applies.

(iii) *Apportionment of contract research expenses.* If contract research is performed partly in the United States, the Commonwealth of Puerto Rico and other possessions of the United States and partly outside the United States, the Commonwealth of Puerto Rico and other possessions of the United States, only 65 percent (or 75 percent in the case of amounts paid to qualified research consortia) of the portion of the contract amount that is attributable to the research activity performed in the United States, the Commonwealth of Puerto Rico and other possessions of the United States may qualify as a contract research expense (even if 80 percent or more of the contract amount is for research performed in the United States, the Commonwealth of Puerto Rico and other possessions of the United States).

(8) *Research in the social sciences, etc.* Qualified research does not include research in the social sciences (including economics, business management, and behavioral sciences), arts, or humanities.

(9) *Research funded by any grant, contract, or otherwise.* Qualified research does not include any research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity). To determine the extent to which research is so funded, §1.41–4A(d) applies.

(10) *Illustrations.* The following examples illustrate provisions contained in paragraphs (c)(1) through (9) (excepting paragraphs (c)(6) of this section) of this section. No inference should be drawn from these examples concerning the application of section 41(d)(1) and paragraph (a) of this section to these facts. The examples are as follows:

Example 1. (i) *Facts.* X, a tire manufacturer, develops a new material to use in its tires. X conducts research to determine the changes that will be necessary for X to modify its existing manufacturing processes to manufacture the new tire. X determines that the new tire material retains heat for a longer period of time than the materials X currently uses for tires, and, as a result, the new tire material adheres to the manufacturing equipment during tread cooling. X evaluates several alternatives for processing the treads at cooler temperatures to address this problem, including a new type of belt for its manufacturing equipment to be used in tread cooling. Such a belt is not commercially available. Because X is uncertain of the belt design, X develops and conducts sophisticated engineering tests on several alternative designs for a new type of belt to be used in tread cooling until X successfully achieves a design that meets X's requirements. X then manufactures a set of belts for its production equipment, installs the belts, and tests the belts to make sure they were manufactured correctly.

(ii) *Conclusion.* X's research with respect to the design of the new belts to be used in its manufacturing of the new tire may be qualified research under section 41(d)(1) and paragraph (a) of this section. However, X's expenses to implement the new belts, including the costs to manufacture, install, and test the belts were incurred after the belts met the taxpayer's functional and economic requirements and are excluded as research after commercial production under section 41(d)(4)(A) and paragraph (c)(2) of this section.

Example 2. (i) *Facts.* For several years, X has manufactured and sold a particular kind of widget. X initiates a new research project to develop a new or improved widget.

(ii) *Conclusion.* X's activities to develop a new or improved widget are not excluded from the definition of qualified research under section 41(d)(4)(A) and paragraph (c)(2) of this section. X's activities relating to the development of a new or improved widget constitute a new research project to develop a new business component. X's research activities relating to the development of the new or improved widget, a new business component, are not considered to be activities conducted after the beginning of commercial production under section 41(d)(4)(A) and paragraph (c)(2) of this section.

Example 3. (i) *Facts.* X, a computer software development firm, owns all substantial rights in a general ledger accounting software core program that X markets and licenses to customers. X incurs expenditures in adapting the core software program to the requirements of C, one of X's customers.

(ii) *Conclusion.* Because X's activities represent activities to adapt an existing software program to a particular customer's requirement or need, X's activities are excluded from the definition of qualified research under section 41(d)(4)(B) and paragraph (c)(3) of this section.

Example 4. (i) *Facts.* The facts are the same as in *Example 3*, except that C pays X to adapt the core software program to C's requirements.

(ii) *Conclusion.* Because X's activities are excluded from the definition of qualified research under section 41(d)(4)(B) and paragraph (c)(3) of this section, C's payments to X are not for qualified research and are not considered to be contract research expenses under section 41(b)(3)(A).

Example 5. (i) *Facts.* The facts are the same as in *Example 3*, except that C's own employees adapt the core software program to C's requirements.

(ii) *Conclusion.* Because C's employees' activities to adapt the core software program to C's requirements are excluded from the definition of qualified research under section 41(d)(4)(B) and paragraph (c)(3) of this section, the wages C paid to its employees do not constitute in-house research expenses under section 41(b)(2)(A).

Example 6. (i) *Facts.* X manufacturers and sells rail cars. Because rail cars have numerous specifications related to performance, reliability and quality, rail car designs are subject to extensive, complex testing in the scientific or laboratory sense. B orders passenger rail cars from X. B's rail car requirements differ from those of X's other existing customers only in that B wants fewer seats in its passenger cars and a higher quality seating material and carpet that are commercially available. X manufactures rail cars meeting B's requirements.

(ii) *Conclusion.* X's activities to manufacture rail cars for B are excluded from the definition of qualified research. The rail car sold to B was not a new business component, but merely an adaptation of an existing business component that did not require a process of experimentation. Thus, X's activities to manufacture rail cars for B are excluded from the definition of qualified research under section 41(d)(4)(B) and paragraph (c)(3) of this section because X's activities represent activities to adapt an existing business component to a particular customer's requirement or need.

Example 7. (i) *Facts.* X, a manufacturer, undertakes to create a manufacturing process for a new valve design. X determines that it requires a specialized type of robotic equipment to use in the manufacturing process for its new valves. Such robotic equipment is not commercially available, and X, therefore, purchases the existing robotic equipment for the purpose of modifying it to meet its needs. X's engineers identify uncertainty that is technological in nature concerning how to modify the existing robotic equipment to meet its needs. X's engineers develop several alternative designs, and conduct experiments using modeling and simulation in modifying the robotic equipment and conduct extensive scientific and laboratory testing of design alternatives. As a result of this process, X's engineers develop a design for the robotic equipment that meets X's needs. X constructs and installs the modified robotic equipment on its manufacturing process.

(ii) *Conclusion.* X's research activities to determine how to modify X's robotic equipment for its manufacturing process are not excluded from the definition of qualified research under section 41(d)(4)(B) and paragraph (c)(3) of this section, provided that X's research activities satisfy the requirements of section 41(d)(1).

Example 8. (i) *Facts.* An existing gasoline additive is manufactured by Y using three ingredients, A, B, and C. X seeks to develop and manufacture its own gasoline additive that appears and functions in a manner similar to Y's additive. To develop its own additive, X first inspects the composition of Y's additive, and uses knowledge gained from the inspection to reproduce A and B in the laboratory. Any differences between ingredients A and B that are used in Y's additive and those reproduced by X are insignificant and are not material to the viability, effectiveness, or cost of A and B. X desires to use with A and B an ingredient that has a materially lower cost than ingredient C. Accordingly, X engages in a process of experimentation to develop, analyze and test potential alternative formulations of the additive.

(ii) *Conclusion.* X's activities in analyzing and reproducing ingredients A and B involve duplication of existing business components and are excluded from the definition of qualified research under section 41(d)(4)(C) and paragraph (c)(4) of this section. X's experimentation activities to develop potential alternative formulations of the additive do not involve duplication of an existing business component and are not excluded from the definition of qualified research under section 41(d)(4)(C) and paragraph (c)(4) of this section.

Example 9. (i) *Facts.* X, a manufacturing corporation, undertakes to restructure its manufacturing organization. X organizes a team to design an organizational structure that will improve X's business operations. The team includes X's employees as well as outside management consultants. The team studies current operations, interviews X's employees, and studies the structure of other manufacturing facilities to determine appropriate modifications to X's current business operations. The team develops a recommendation of proposed modifications which it presents to X's management. X's management approves the team's recommendation and begins to implement the proposed modifications.

(ii) *Conclusion.* X's activities in developing and implementing the new management structure are excluded from the definition of qualified research under section 41(d)(4)(D) and paragraph (c)(5) of this section. Qualified research does not include activities relating to management functions or techniques including management organization plans and management-based changes in production processes.

Example 10. (i) *Facts.* X, an insurance company, develops a new life insurance product. In the course of developing the product, X engages in research with respect to the effect of pricing and tax consequences on demand for the product, the expected volatility of interest rates, and the expected mortality rates (based on published data and prior insurance claims).

(ii) *Conclusion.* X's activities related to the new product represent research in the social sciences (including economics and business management) and are thus excluded from the definition of qualified research under section 41(d)(4)(G) and paragraph (c)(8) of this section.

(d) *Recordkeeping for the research credit.* A taxpayer claiming a credit under section 41 must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit. For the rules governing record retention, see §1.6001–1. To facilitate compliance and administration, the IRS and taxpayers may agree to guidelines for the keeping of specific records for purposes of substantiating research credits.

(e) *Effective/applicability dates.* Other than paragraph (c)(6) of this section, this section is applicable for taxable years ending on or after December 31, 2003. Paragraph (c)(6) of this section is applicable for taxable years beginning on or after October 4, 2016. For any taxable year that both ends on or after January 20, 2015 and begins before October 4, 2016, the IRS will not challenge return positions consistent with all of paragraph (c)(6) of this section or all of paragraph (c)(6) of this section as contained in the Internal Revenue Bulletin (IRB) 2015–5 (see *www.irs.gov/pub/irs-irbs/irb15-05.pdf*). For taxable years ending before January 20, 2015, taxpayers may choose to follow either all of §1.41–4(c)(6) as contained in 26 CFR part 1 (revised as of April 1, 2003) and IRB 2001–5 (see *www.irs.gov/pub/irs-irbs/irb01-05.pdf*) or all of §1.41–4(c)(6) as contained in IRB 2002–4 (see *www.irs.gov/pub/irs-irbs/irb02-04.pdf*).

[T.D. 8930, 66 FR 290, Jan. 3, 2001, as amended by T.D. 9104, 69 FR 26, Jan. 2, 2004; T.D. 9786, 81 FR 68307, Oct. 4, 2016; 81 FR 76496, Nov. 3, 2016]

§ 1.41–4A Qualified research for taxable years beginning before January 1, 1986.

(a) *General rule.* Except as otherwise provided in section 30(d) (as that section read before amendment by the Tax Reform Act of 1986) and in this section, the term "qualified research" means research, expenditures for which would be research and experimental expenditures within the meaning of section 174. Expenditures that are ineligible for the section 174 deduction elections are not expenditures for qualified research. For example, expenditures for the acquisition of land or depreciable property used in research, and mineral exploration costs described in section 174(d), are not expenditures for qualified research.

(b) *Activities outside the United States*—(1) *In-house research.* In-house research conducted outside the United States (as defined in section 7701(a)(9)) cannot constitute qualified research. Thus, wages paid to an employee scientist for services performed in a laboratory in the United States and in a test station in Antarctica must be apportioned between the services performed within the United States and the services performed outside the United States, and only the wages apportioned to the services conducted within the United States are qualified research expenses unless the 80 percent rule of §1.41–2(d)(2) applies.

(2) *Contract research.* If contract research is performed partly within the United States and partly without, only 65 percent of the portion of the contract amount that is attributable to the research performed within the United States can qualify as contract research expense (even if 80 percent or more of the contract amount was for research performed in the United States).

(c) *Social sciences or humanities.* Qualified research does not include research in the social sciences or humanities. For purposes of section 30(d)(2) (as that section read before amendment by the Tax Reform Act of 1986) and of this section, the phrase "research in the social sciences or humanities" encompasses all areas of research other than research in a field of laboratory science (such as physics or biochemistry), engineering or technology. Examples of research in the social sciences or humanities include the development of a new life insurance contract, a new economic model or theory, a new accounting procedure or a new cookbook.

(d) *Research funded by any grant, contract, or otherwise*—(1) *In general.* Research does not constitute qualified research to the extent it is funded by any grant, contract, or otherwise by another person (including any governmental entity). All agreements (not only research contracts) entered into between the taxpayer performing the research and other persons shall be considered in determining the extent to which the research is funded.

Amounts payable under any agreement that are contingent on the success of the research and thus considered to be paid for the product or result of the research (see § 1.41–2(e)(2)) are not treated as funding. For special rules regarding funding between commonly controlled businesses, see § 1.41–6(e).

(2) *Research in which taxpayer retains no rights.* If a taxpayer performing research for another person retains no substantial rights in research under the agreement providing for the research, the research is treated as fully funded for purposes of section 41(d)(4)(H), and no expenses paid or incurred by the taxpayer in performing the research are qualified research expenses. For example, if the taxpayer performs research under an agreement that confers on another person the exclusive right to exploit the results of the research, the taxpayer is not performing qualified research because the research is treated as fully funded under this paragraph (d)(2). Incidental benefits to the taxpayer from performance of the research (for example, increased experience in a field of research) do not constitute substantial rights in the research. If a taxpayer performing research for another person retains no substantial rights in the research and if the payments to the researcher are contingent upon the success of the research, neither the performer nor the person paying for the research is entitled to treat any portion of the expenditures as qualified research expenditures.

(3) *Research in which the taxpayer retains substantial rights*—(i) *In general.* If a taxpayer performing research for another person retains substantial rights in the research under the agreement providing for the research, the research is funded to the extent of the payments (and fair market value of any property) to which the taxpayer becomes entitled by performing the research. A taxpayer does not retain substantial rights in the research if the taxpayer must pay for the right to use the results of the research. Except as otherwise provided in paragraph (d)(3)(ii) of this section, the taxpayer shall reduce the amount paid or incurred by the taxpayer for the research that would, but for section 41(d)(4)(H), constitute qualified research expenses of the taxpayer by the amount of funding determined under the preceding sentence.

(ii) *Pro rata allocation.* If the taxpayer can establish to the satisfaction of the district director—

(A) The total amount of research expenses,

(B) That the total amount of research expenses exceed the funding, and

(C) That the otherwise qualified research expenses (that is, the expenses which would be qualified research expenses if there were no funding) exceed 65 percent of the funding, then the taxpayer may allocate the funding pro rata to nonqualified and otherwise qualified research expenses, rather than allocating it 100 percent to otherwise qualified research expenses (as provided in paragraph (d)(3)(i) of this section). In no event, however, shall less than 65 percent of the funding be applied against the otherwise qualified research expenses.

(iii) *Project-by-project determination.* The provisions of this paragraph (d)(3) shall be applied separately to each research project undertaken by the taxpayer.

(4) *Independent research and development under the Federal Acquisition Regulations System and similar provisions.* The Federal Acquisition Regulations System and similar rules and regulations relating to contracts (fixed price, cost plus, etc.) with government entities provide for allocation of certain ‘‘independent research and development costs’’ and ‘‘bid and proposal costs’’ of a contractor to contracts entered into with that contractor. In general, any ‘‘independent research and development costs’’ and ‘‘bid and proposal costs’’ paid to a taxpayer by reason of such a contract shall not be treated as funding the underlying research activities except to the extent the ‘‘independent research and development costs’’ and ‘‘bid and proposal costs’’ are properly severable from the contract. See § 1.451–3(e); see also section 804(d)(2) of the Tax Reform Act of 1986.

(5) *Funding determinable only in subsequent taxable year.* If at the time the taxpayer files its return for a taxable year, it is impossible to determine to

what extent particular research performed by the taxpayer during that year may be funded, then the taxpayer shall treat the research as completely funded for purposes of completing that return. When the amount of funding is finally determined, the taxpayer should amend the return and any interim returns to reflect the proper amount of funding.

(6) *Examples.* The following examples illustrate the application of the principles contained in this paragraph.

Example 1. A enters into a contract with B Corporation, a cash-method taxpayer using the calendar year as its taxable year, under which B is to perform research that would, but for section 41(d)(3)(H), be qualified research of B. The agreement calls for A to pay B $120x, regardless of the outcome of the research. In 1982, A makes full payment of $120x under the contract, B performs all the research, and B pays all the expenses connected with the research, as follows:

In-house research expenses	$100x
Outside research:	
(Amount B paid to third parties for research, 65 percent of which ($26x) is treated as a contract research expense of B)	40x
Overhead and other expenses	10x
Total	150x

If B has no rights to the research, B is fully funded. Alternatively, assume that B retains the right to use the results of the research in carrying on B's business. Of B's otherwise qualified research expenses of $126x + $26x), $120x is treated as funded by A. Thus $6x ($126x − $120x) is treated as a qualified research expense of B. However, if B establishes the facts required under paragraph (d)(3) of this section, B can allocate the funding pro rata to nonqualified and otherwise qualified research expenses. Thus $100.8x ($120x ($126x/$150x)) would be allocated to otherwise qualified research expenses. B's qualified research expenses would be $25.2x ($126x − $100.8x). For purposes of the following examples (2), (3) and (4) assume that B retains substantial rights to use the results of the research in carrying on B's business.

Example 2. The facts are the same as in example (1) (assuming that B retains the right to use the results of the research in carrying on B's business) except that, although A makes full payment of $120x during 1982, B does not perform the research or pay the associated expenses until 1983. The computations are unchanged. However, B's qualified research expenses determined in example (1) are qualified research expenses during 1983.

Example 3. The facts are the same as in example (1) (assuming that B retains the right to use the results of the research in carrying on B's business) except that, although B performs the research and pays the associated expenses during 1982, A does not pay the $120x until 1983. The computations are unchanged and the amount determined in example (1) is a qualified research expense of B during 1982.

Example 4. The facts are the same as in example (1) (assuming that B retains the right to use the results of the research in carrying on B's business) except that, instead of agreeing to pay B $120x, A agrees to pay $100x regardless of the outcome and an additional $20x only if B's research produces a useful product. B's research produces a useful product and A pays B $120x during 1982. The $20x payment that is conditional on the success of the research is not treated as funding. Assuming that B establishes to the satisfaction of the district director the actual research expenses, B can allocate the funding to nonqualified and otherwise qualified research expenses. Thus $84x ($100x ($126x/$150x)) would be allocated to otherwise qualified research expenses. B's qualified research expenses would be $42x ($126x − $84x).

Example 5. C enters into a contract with D, a cash-method taxpayer using the calendar year as its taxable year, under which D is to perform research in which both C and D will have substantial rights. C agrees to reimburse D for 80 percent of D's expenses for the research. D performs part of the research in 1982 and the rest in 1983. At the time that D files its return for 1982, D is unable to determine the extent to which the research is funded under the provisions of this paragraph. Under these circumstances, D may not treat any of the expenses paid by D for this research during 1982 as qualified research expenses on its 1982 return. When the project is complete and D can determine the extent of funding, D should file an amended return for 1982 to take into account any qualified research expense for 1982.

[T.D. 8251, 54 FR 21204, May 17, 1989. Redesignated and amended by T.D. 8930, 66 FR 295, Jan. 3, 2001]

§ 1.41–5 Basic research for taxable years beginning after December 31, 1986. [Reserved]

§ 1.41–5A Basic research for taxable years beginning before January 1, 1987.

(a) *In general.* The amount expended for basic research within the meaning of section 30(e) (before amended by the Tax Reform Act of 1986) equals the sum of money plus the taxpayer's basis in tangible property (other than land) transferred for use in the performance of basic research.

(b) *Trade or business requirement.* Any amount treated as a contract research expense under section 30(e) (before amendment by the Tax Reform Act of 1986) shall be deemed to have been paid or incurred in carrying on a trade or business, if the corporation that paid or incurred the expenses is actually engaged in carrying on some trade or business.

(c) *Prepaid amounts*—(1) *In general.* If any basic research expense paid or incurred during any taxable year is attributable to research to be conducted after the close of such taxable year, the expense so attributable shall be treated for purposes of section 30(b)(1)(B) (before amendment by the Tax Reform Act of 1986) as paid or incurred during the period in which the basic research is conducted.

(2) *Transfers of property.* In the case of transfers of property to be used in the performance of basic research, the research in which that property is to be used shall be considered to be conducted ratably over a period beginning on the day the property is first so used and continuing for the number of years provided with respect to property of that class under section 168(c)(2) (before amendment by the Tax Reform Act of 1986). For example, if an item of property which is 3-year property under section 168(c) is transferred to a university for basic research on January 12, 1983, and is first so used by the university on March 1, 1983, then the research in which that property is used is considered to be conducted ratably from March 1, 1983, through February 28, 1986.

(d) *Written research agreement*—(1) *In general.* A written research agreement must be entered into prior to the performance of the basic research.

(2) *Agreement between a corporation and a qualified organization after June 30, 1983*—(i) *In general.* A written research agreement between a corporation and a qualified organization (including a qualified fund) entered into after June 30, 1983, shall provide that the organization shall inform the corporation within 60 days after the close of each taxable year of the corporation what amount of funds provided by the corporation pursuant to the agreement was expended on basic research during the taxable year of the corporation. In determining amounts expended on basic research, the qualified organization shall take into account the exclusions specified in section 30(e)(3) (before amendment by the Tax Reform Act of 1986) and in paragraph (e) of this section.

(ii) *Transfers of property.* In the case of transfers of property to be used in basic research, the agreement shall provide that substantially all use of the property is to be for basic research, as defined in section 30(e)(3) (before amendment by the Tax Reform Act of 1986).

(3) *Agreement between a qualified fund and a qualified educational organization after June 30, 1983.* A written research agreement between a qualified fund and a qualified educational organization (see section 30(e)(4)(B)(iii) (before amendment by the Tax Reform Act of 1986)) entered into after June 30, 1983, shall provide that the qualified educational organization shall furnish sufficient information to the qualified fund to enable the qualified fund to comply with the written research agreements it has entered into with grantor corporations, including the requirement set forth in paragraph (d)(2) of this section.

(e) *Exclusions*—(1) *Research conducted outside the United States.* If a taxpayer pays or incurs an amount for basic research to be performed partly within the United States and partly without, only 65 percent of the portion of the amount attributable to research performed within the United States can be treated as a contract research expense (even if 80 percent or more of the contract amount was for basic research performed in the United States).

(2) *Research in the social sciences or humanities.* Basic research does not include research in the social sciences or humanities, within the meaning of §1.41–4A(c).

(f) *Procedure for making an election to be treated as a qualified fund.* In order to make an election to be treated as a qualified fund within the meaning of section 30(e)(4)(B)(iii) (before amendment by the Tax Reform Act of 1986) or as an organization described in section

41(e)(6)(D), the organization shall file with the Internal Revenue Service center with which it files its annual return a statement that—

(1) Sets out the name, address, and taxpayer identification number of the electing organization (the ''taxpayer'') and of the organization that established and maintains the electing organization (the ''controlling organization''),

(2) Identifies the election as an election under section 41(e)(6)(D) of the Code,

(3) Affirms that the controlling organization and the taxpayer are section 501(c)(3) organizations,

(4) Provides that the taxpayer elects to be treated as a private foundation for all Code purposes other than section 4940,

(5) Affirms that the taxpayer satisfies the requirement of section 41(e)(6)(D)(iii), and

(6) Specifies the date on which the election is to become effective.

If an election to be treated as a qualified fund is filed before February 1, 1982, the election may be made effective as of any date after June 30, 1981, and before January 1, 1986. If an election is filed on or after February 1, 1982, the election may be made effective as of any date on or after the date on which the election is filed.

[T.D. 8251, 54 FR 21204, May 17, 1989. Redesignated and amended by T.D. 8930, 66 FR 295, Jan. 3, 2001]

§ 1.41–6 Aggregation of expenditures.

(a) *Controlled group of corporations; trades or businesses under common control*—(1) *In general*. To determine the amount of research credit (if any) allowable to a trade or business that at the end of its taxable year is a member of a controlled group, a taxpayer must—

(i) Compute the group credit in the manner described in paragraph (b) of this section; and

(ii) Allocate the group credit among the members of the group in the manner described in paragraph (c) of this section.

(2) *Consolidated groups*. For special rules relating to consolidated groups, see paragraph (d) of this section.

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

(i) *Consolidated group* has the meaning set forth in §1.1502–1(h).

(ii) *Controlled group* and *group* mean a controlled group of corporations, as defined in section 41(f)(5), or a group of trades or businesses under common control. For rules for determining whether trades or businesses are under common control, see §1.52–1 (b) through (g).

(iii) *Credit year* means the taxable year for which the member is computing the credit.

(iv) *Group credit* means the research credit (if any) allowable to a controlled group.

(v) *Trade or business* means a sole proprietorship, a partnership, a trust, an estate, or a corporation that is carrying on a trade or business (within the meaning of section 162). Any corporation that is a member of a commonly controlled group shall be deemed to be carrying on a trade or business if any other member of that group is carrying on any trade or business.

(b) *Computation of the group credit*—(1) *In general*. All members of a controlled group are treated as a single taxpayer for purposes of computing the research credit. The group credit is compute2d by applying all of the section 41 computational rules on an aggregate basis. All members of a controlled group must use the same method of computation: The method described in section 41(a)(1), the alternative incremental credit (AIRC) method described in section 41(c)(4) (available for years beginning on or before December 31, 2008), or the alternative simplified credit (ASC) method described in section 41(c)(5), in computing the group credit for a credit year.

(2) *Start-up companies*—(i) *In general*. For purposes of computing the group credit, a controlled group is treated as a start-up company for purposes of section 41(c)(3)(B)(i) if—

(A) There was no taxable year beginning before January 1, 1984, in which a member of the group had gross receipts and either the same member or another member also had qualified research expenditures (QREs); or

(B) There were fewer than three taxable years beginning after December 31, 1983, and before January 1, 1989, in which a member of the group had gross receipts and either the same member or another member also had QREs.

(ii) *Example.* The following example illustrates the principles of paragraph (b)(2)(i) of this section:

Example. A, B, and C, all of which are calendar year taxpayers, are members of a controlled group. During the 1983 taxable year, A had QREs, but no gross receipts; B had gross receipts, but no QREs; and C had no QREs or gross receipts. The 1984 taxable year was the first taxable year for which each of A, B, and C had both QREs and gross receipts. A, B, and C had both QREs and gross receipts in 1985, 1986, 1987, and 1988. Because the first taxable year for which each of A, B, and C had both QREs and gross receipts began after December 31, 1983, each of A, B, and C is a start-up company under section 41(c)(3)(B)(i) and each is a start-up company for purposes of computing the stand-alone entity credit. During the 1983 taxable year, at least one member of the group, A, had QREs and at least one member of the group, B, had gross receipts, thus, the group had both QREs and gross receipts in 1983. Therefore, the controlled group is not a start-up company because the first taxable year for which the group had both QREs and gross receipts did not begin after December 31, 1983, and there were not fewer than three taxable years beginning after December 31, 1983, and before January 1, 1989, in which a member of the group had gross receipts and QREs.

(iii) *First taxable year after December 31, 1993, for which the controlled group had QREs.* In the case of a controlled group that is treated as a start-up company under section 41(c)(3)(B)(i) and paragraph (b)(2)(i) of this section, for purposes of determining the group's fixed-base percentage under section 41(c)(3)(B)(ii), the first taxable year after December 31, 1993, for which the group has QREs is the first taxable year in which at least one member of the group has QREs.

(iv) *Example.* The following example illustrates the principles of paragraph (b)(2)(iii) of this section:

Example. D, E, and F, all of which are calendar year taxpayers, are members of a controlled group. The group is treated as a start-up company under section 41(c)(3)(B)(i) and paragraph (b)(2)(i) of this section. The first taxable year after December 31, 1993, for which D had QREs was 1994. The first taxable year after December 31, 1993, for which E had QREs was 1995. The first taxable year after December 31, 1993, for which F had QREs was 1996. Because the 1994 taxable year was the first taxable year after December 31, 1993, for which at least one member of the group, D, had QREs, for purposes of determining the group's fixed-based percentage under section 41(c)(3)(B)(ii), the 1994 taxable year was the first taxable year after December 31, 1993, for which the group had QREs.

(c) [Reserved]. For further guidance, see §1.41–6T(c).

(d) *Special rules for consolidated groups*—(1) [Reserved]. For further guidance, see §1.41–6T(d)(1).

(2) *Start-up company status.* A consolidated group's status as a start-up company and the first taxable year after December 31, 1993, for which a consolidated group has QREs are determined in accordance with the principles of paragraph (b)(2) of this section.

(3) [Reserved]. For further guidance, see §1.41–6T(d)(3).

(e) [Reserved]. For further guidance, see §1.41–6T(e).

(f) *For taxable years beginning before January 1, 1990.* For taxable years beginning before January 1, 1990, see §1.41–6 as contained in 26 CFR part 1, revised April 1, 2005.

(g) *Tax accounting periods used*—(1) *In general.* The credit allowable to a member of a controlled group is that member's share of the group credit computed as of the end of that member's taxable year. In computing the group credit for a group whose members have different taxable years, a member generally should treat the taxable year of another member that ends with or within the credit year of the computing member as the credit year of that other member. For example, Q, R, and S are members of a controlled group of corporations. Both Q and R are calendar year taxpayers. S files a return using a fiscal year ending June 30. For purposes of computing the group credit at the end of Q's and R's taxable year on December 31, S's fiscal year ending June 30, which ends within Q's and R's taxable year, is treated as S's credit year.

(2) *Special rule when timing of research is manipulated.* If the timing of research by members using different tax accounting periods is manipulated to generate a credit in excess of the amount that would be allowable if all members of the group used the same

tax accounting period, then the appropriate Internal Revenue Service official in the operating division that has examination jurisdiction of the return may require each member of the group to calculate the credit in the current taxable year and all future years as if all members of the group had the same taxable year and base period as the computing member.

(h) *Membership during taxable year in more than one group.* A trade or business may be a member of only one group for a taxable year. If, without application of this paragraph, a business would be a member of more than one group at the end of its taxable year, the business shall be treated as a member of the group in which it was included for its preceding taxable year. If the business was not included for its preceding taxable year in any group in which it could be included as of the end of its taxable year, the business shall designate in its timely filed (including extensions) return the group in which it is being included. If the return for a taxable year is due before July 1, 1983, the business may designate its group membership through an amended return for that year filed on or before June 30, 1983. If the business does not so designate, then the appropriate Internal Revenue Service official in the operating division that has examination jurisdiction of the return will determine the group in which the business is to be included.

(i) *Intra-group transactions*—(1) *In general.* Because all members of a group under common control are treated as a single taxpayer for purposes of determining the research credit, transfers between members of the group are generally disregarded.

(2) *In-house research expenses.* If one member of a group performs qualified research on behalf of another member, the member performing the research shall include in its QREs any in-house research expenses for that work and shall not treat any amount received or accrued as funding the research. Conversely, the member for whom the research is performed shall not treat any part of any amount paid or incurred as a contract research expense. For purposes of determining whether the in-house research for that work is qualified research, the member performing the research shall be treated as carrying on any trade or business carried on by the member on whose behalf the research is performed.

(3) *Contract research expenses.* If a member of a group pays or incurs contract research expenses to a person outside the group in carrying on the member's trade or business, that member shall include those expenses as QREs. However, if the expenses are not paid or incurred in carrying on any trade or business of that member, those expenses may be taken into account as contract research expenses by another member of the group provided that the other member—

(i) Reimburses the member paying or incurring the expenses; and

(ii) Carries on a trade or business to which the research relates.

(4) *Lease payments.* The amount paid or incurred to another member of the group for the lease of personal property owned by a member of the group is not taken into account for purposes of section 41. Amounts paid or incurred to another member of the group for the lease of personal property owned by a person outside the group shall be taken into account as in-house research expenses for purposes of section 41 only to the extent of the lesser of—

(i) The amount paid or incurred to the other member; or

(ii) The amount of the lease expenses paid to the person outside the group.

(5) *Payment for supplies.* Amounts paid or incurred to another member of the group for supplies shall be taken into account as in-house research expenses for purposes of section 41 only to the extent of the lesser of—

(i) The amount paid or incurred to the other member; or

(ii) The amount of the other member's basis in the supplies.

(j) *Effective/applicability dates*—(1) *In general.* Except for paragraph (d) of this section, these regulations are applicable for taxable years ending on or after May 24, 2005. Generally, a taxpayer may use any reasonable method of computing and allocating the credit (including use of the consolidated group rule contained in paragraph (d) of this section) for taxable years ending before May 24, 2005. However, paragraph (b) of this section, relating to the computation of the group credit, and paragraph (c) of this section, relating to the allocation of the group credit, (applied without regard to paragraph (d) of this section) will apply to taxable years ending on or after December 29, 1999, if the members of a controlled group, as a whole, claimed more than 100 percent of the amount that would be allowable under paragraph (b) of this section. In the case of a controlled group whose members have different taxable years and whose members use inconsistent methods of allocation, the members of the controlled group shall be deemed to have, as a whole, claimed more than 100 percent of the amount that would be allowable under paragraph (b) of this section.

(2) *Consolidated group rule.* Paragraph (d) of this section is applicable for taxable years ending on or after November 9, 2006. For taxable years ending on or after May 24, 2005, and before November 9, 2006, see § 1.41–6T(d) as contained in 26 CFR part 1, revised April 1, 2006.

(3) *Taxable years ending after June 9, 2011.* Paragraphs (b)(1), (c)(2), and (e) of this section are applicable for taxable years ending after June 9, 2011. For taxable years ending on or before June 9, 2011, see §§ 1.41–6T and 1.41–6 as contained in 26 CFR part 1, revised April 1, 2011.

(4) *Taxable years beginning after December 31, 2011.* [Reserved]. For further guidance, see § 1.41–6T(j)(4).

(5) *Taxable years ending before January 1, 2012.* [Reserved]. For further guidance, see § 1.41–6T(j)(5).

[T.D. 9296, 71 FR 65725, Nov. 9, 2006; 71 FR 70875, Dec. 7, 2006; 71 FR 75614, Dec. 15, 2006; T.D. 9401, 73 FR 34188, June 17, 2008; T.D. 9528, 76 FR 33995, June 10, 2011; T.D. 9717, 80 FR 18098, Apr. 3, 2015]

EFFECTIVE DATE NOTE: At 83 FR 13184, Mar. 28, 2018, § 1.41–6 was amended by revising paragraphs (c), (d)(1) and (3), (e), and (j)(4) and (5), effective Apr. 2, 2018. For the convenience of the user, the revised text is set forth as follows:

§ 1.41–6 Aggregation of expenditures.* * * * *

(c) *Allocation of the group credit.* The group credit is allocated to each member of the controlled group on a proportionate basis to its share of the aggregate of the qualified research expenses, basic research payments, and amounts paid or incurred to energy research consortiums taken into account for the taxable year by such controlled group for purposes of the credit. For purposes of paragraphs (c), (d), and (e) of this section, qualified research expenses, basic research payments, and amounts paid or incurred to energy research consortiums are collectively referred to as QREs.

(d) *Special rules for consolidated groups*—(1) *In general.* For purposes of applying paragraph (c) of this section, members of a consolidated group who are members of a controlled group are treated as a single member of the controlled group.* * * * *

(3) *Special rule for allocation of group credit among consolidated group members.* The portion of the group credit that is allocated to a consolidated group is allocated to each member of the consolidated group on a proportionate basis to its share of the aggregate of the QREs taken into account for the taxable year by such consolidated group for purposes of the credit.

(e) *Examples.* The following examples illustrate the provisions of paragraphs (c) and (d) of this section.

Example 1. Controlled group. A, B, and C are a controlled group. A had $100x, B $300x, and C $500x of qualified research expenses for the year, totaling $900x for the group. A, in the course of its trade or business, also made a payment of $100x to an energy research consortium for energy research. The group's QREs total 1,000x and the group calculated its total research credit to be $60x for the year. Based on each member's proportionate share of the controlled group's aggregate QREs, A is allocated $12x, B $18x, and C $30x of the credit.

Example 2. Consolidated group is a member of controlled group. The controlled group's members are D, E, F, G, and H. F, G, and H file a consolidated return and are treated as a single member (FGH) of the controlled group. D had $240x, E $360x, and FGH $600x of qualified research expenses for the year ($1,200x aggregate). The group calculated its research credit to be $100x for the year. Based on the proportion of each member's share of QREs to the controlled group's aggregate QREs for the taxable year D is allocated $20x, E $30x, and FGH $50x of the credit. The $50x of credit allocated to FGH is then allocated to the consolidated group members based on the proportion of each consolidated group member's share of QREs to the consolidated group's aggregate QREs. F had $120x, G $240x, and H $240x of QREs for the year. Therefore, F is allocated $10x, G is allocated $20x, and H is allocated $20x.* * * * *

(j) * * *

(4) *Taxable years beginning after December 31, 2011.* Paragraphs (c), (d)(1) and (3), (e), and (j)(4) and (5) of this section apply to taxable years beginning on or after April 2, 2018. For taxable years ending before April 2, 2018, see § 1.41–6T as contained in 26 CFR part 1, as revised April 1, 2017.

(5) *Taxable years beginning before January 1, 2012.* See § 1.41–6 as contained in 26 CFR part 1, revised April 1, 2014.

§ 1.41–6T. Aggregation of expenditures (temporary).

(a) through (b) [Reserved]. For further guidance, see § 1.41–6(a) through (b).

(c) *Allocation of the group credit.* The group credit is allocated to each member of the controlled group on a proportionate basis to its share of the aggregate of the qualified research expenses, basic research payments, and amounts paid or incurred to energy research consortiums (collectively "QREs" for purposes of paragraphs (c), (d), and (e) of this section) taken into account for the taxable year by such controlled group for purposes of the credit.

(d) *Special rules for consolidated groups*—(1) *In general.* For purposes of applying paragraph (c) of this section, members of a consolidated group who are members of a controlled group are treated as a single member of the controlled group.

(2) [Reserved]. For further guidance, see § 1.41–6(d)(2).

(3) *Special rule for allocation of group credit among consolidated group members.* The portion of the group credit that is allocated to a consolidated group is allocated to each member of the consolidated group on a proportionate basis to its share of the aggregate of the QREs taken into account for the taxable year by such consolidated group for purposes of the credit.

(e) *Examples.* The following examples illustrate the provisions of paragraphs (c) and (d) of this section.

Example 1. Controlled group. A, B, and C are a controlled group. A had $100x, B $300x, and C $500x of qualified research expenses for the year, totaling $900x for the group. A, in the course of its trade or business, also made a payment of $100x to an energy research consortium for energy research. The group's QREs total 1000x and the group calculated its total research credit to be $60x for the year. Based on each member's proportionate share of the controlled group's aggregate QREs, A is allocated $12x, B $18x, and C $30x of the credit.

Example 2. Consolidated group is a member of controlled group. The controlled group's members are D, E, F, G, and H. F, G, and H file a consolidated return and are treated as a single member (FGH) of the controlled group. D had $240x, E $360x, and FGH $600x of qualified research expenses for the year ($1,200x aggregate). The group calculated its research credit to be $100x for the year. Based on the proportion of each member's share of QREs to the controlled group's aggregate QREs for the taxable year D is allocated $20x, E $30x, and FGH $50x of the credit. The $50x of credit allocated to FGH is then allocated to the consolidated group members based on the proportion of each consolidated group member's share of QREs to the consolidated group's aggregate QREs. F had $120x, G $240x, and H $240x of QREs for the year. Therefore, F is allocated $10x, G is allocated $20x, and H is allocated $20x.

(f) through (i) [Reserved]. For further guidance, see § 1.41–6(f) through (i).

(j)(1) through (3) [Reserved]. For further guidance, see § 1.41–6(j)(1) through (3).

(4) *Taxable years beginning after December 31, 2011.* Section 1.41–6T is applicable for taxable years beginning on or after April 3, 2015. Taxpayers may apply § 1.41–6T to taxable years beginning after December 31, 2011, but before April 3, 2015. For a taxpayer that does not apply § 1.41–6T to a taxable year beginning after December 31, 2011, but before April 3, 2015, the guidance that applies to such taxable year is contained in Notice 2013–20 (2013–15 IRB 902).

(5) *Taxable years beginning before January 1, 2012.* See § 1.41–6 as contained in 26 CFR part 1, revised April 1, 2014.

(6) *Expiration date.* The applicability of § 1.41–6T expires on April 2, 2018.

[T.D. 9717, 80 FR 18098, Apr. 3, 2015]

EFFECTIVE DATE NOTE: At 83 FR 13185, Mar. 28, 2018, § 1.41–6T was removed, effective Apr. 2, 2018.

§ 1.41–7 Special rules.

(a) *Allocations*—(1) *Corporation making an election under subchapter S*—(i) *Pass-through, for taxable years beginning after December 31, 1982, in the case of an S corporation.* In the case of an S corporation (as defined in section 1361) the amount of research credit computed for the corporation shall be allocated to the shareholders according to the provisions of section 1366 and section 1377.

(ii) *Pass-through, for taxable years beginning before January 1, 1983, in the case of a subchapter S corporation.* In the case of an electing small business corporation (as defined in section 1371 as that section read before the amendments made by the subchapter S Revision Act of 1982), the amount of the research credit computed for the corporation for any taxable year shall be apportioned pro rata among the persons who are shareholders of the corporation on the last day of the corporation's taxable year.

(2) *Pass-through in the case of an estate or trust.* In the case of an estate or trust, the amount of the research credit computed for the estate or trust for any taxable year shall be apportioned among the estate or trust and the beneficiaries on the basis of the income of the estate or trust allocable to each.

(3) *Pass-through in the case of a partnership*—(i) *In general.* In the case of a partnership, the research credit computed for the partnership for any taxable year shall be apportioned among the persons who are partners during the taxable year in accordance with section 704 and the regulations thereunder. See, for example, §1.704–1(b)(4)(ii). Because the research credit is an expenditure-based credit, the credit is to be allocated among the partners in the same proportion as section 174 expenditures are allocated for the year.

(ii) *Certain expenditures by joint ventures.* Research expenses to which §1.41–2(a)(4)(ii) applies shall be apportioned among the persons who are partners during the taxable year in accordance with the provisions of that section. For purposes of section 41, these expenses shall be treated as paid or incurred directly by the partners rather than by the partnership. Thus, the partnership shall disregard these expenses in computing the credit to be apportioned under paragraph (a)(3)(i) of this section, and in making the computations under section 41 each partner shall aggregate its distributive share of these expenses with other research expenses of the partner. The limitation on the amount of the credit set out in section 41(g) and in paragraph (c) of this section shall not apply because the credit is computed by the partner, not the partnership.

(4) *Year in which taken into account.* An amount apportioned to a person under this paragraph shall be taken into account by the person in the taxable year of such person which or within which the taxable year of the corporation, estate, trust, or partnership (as the case may be) ends.

(5) *Credit allowed subject to limitation.* The credit allowable to any person to whom any amount has been apportioned under paragraph (a)(1), (2) or (3)(i) of this section is subject to section 41(g) and sections 38 and 39 of the Code, if applicable.

(b) *Adjustments for certain acquisitions and dispositions—Meaning of terms.* For the meaning of "acquisition," "separate unit," and "major portion," see paragraph (b) of §1.52–2. An "acquisition" includes an incorporation or a liquidation.

(c) *Special rule for pass-through of credit.* The special rule contained in section 41(g) for the pass-through of the credit in the case of an individual who owns an interest in an unincorporated trade or business, is a partner in a partnership, is a beneficiary of an estate or trust, or is a shareholder in an S corporation shall be applied in accordance with the principles set forth in §1.53–3.

(d) *Carryback and carryover of unused credits.* The taxpayer to whom the credit is passed through under paragraph (c) of this section shall not be prevented from applying the unused portion in a carryback or carryover year merely because the entity that earned the credit changes its form of conducting business.

[T.D. 8251, 54 FR 21204, May 17, 1989. Redesignated by T.D. 8930, 66 FR 295, Jan. 3, 2001]

§1.41–8 Alternative incremental credit applicable for taxable years beginning on or before December 31, 2008.

(a) *Determination of credit.* At the election of the taxpayer, the credit determined under section 41(a)(1) equals the amount determined under section 41(c)(4).

(b) *Election*—(1) *In general.* A taxpayer may elect to apply the provisions of the alternative incremental research credit (AIRC) in section 41(c)(4) for any taxable year of the taxpayer beginning after June 30, 1996. If a taxpayer makes an election under section 41(c)(4), the election applies to the taxable year for which made and all subsequent taxable years unless revoked in the manner prescribed in paragraph (b)(3) of this section.

(2) *Time and manner of election.* An election under section 41(c)(4) is made by completing the portion of Form 6765, ''Credit for Increasing Research Activities,'' (or successor form) relating to the election of the AIRC, and attaching the completed form to the taxpayer's timely filed (including extensions) original return for the taxable year to which the election applies. An election under section 41(c)(4) may not be made on an amended return. An extension of time to make an election under section 41(c)(4) will not be granted under §301.9100–3 of this chapter.

(3) *Revocation.* An election under this section may not be revoked except with the consent of the Commissioner. A taxpayer is deemed to have requested, and to have been granted, the consent of the Commissioner to revoke an election under section 41(c)(4) if the taxpayer completes the portion of Form 6765, ''Credit For Increasing Research Activities,'' (or successor form) relating to the amount determined under section 41(a)(1) (the regular credit) or the alternative simplified credit (ASC) and attaches the completed form to the taxpayer's timely filed (including extensions) original return for the year to which the revocation applies. An election under section 41(c)(4) may not be revoked on an amended return. An extension of time to revoke an election under section 41(c)(4) will not be granted under §301.9100–3 of this chapter.

(4) *Special rules for controlled groups*—(i) *In general.* In the case of a controlled group of corporations, all the members of which are not included on a single consolidated return, an election (or revocation) must be made by the designated member by satisfying the requirements of paragraph (b)(2) or (b)(3) of this section (whichever applies), and such election (or revocation) by the designated member shall be binding on all the members of the group for the credit year to which the election (or revocation) relates. If the designated member fails to timely make (or revoke) an election, each member of the group must compute the group credit using the method used to compute the group credit for the immediately preceding credit year.

(ii) *Designated member.* For purposes of this paragraph (b)(4), for any credit year, the term *designated member* means that member of the group that is allocated the greatest amount of the group credit under §1.41–6(c) based on the amount of credit reported on the taxpayer's timely filed (including extensions) original Federal income tax return (even if that member subsequently is determined not to be the designated member). If the members of a group compute the group credit using different methods (the method described in section 41(a)(1), the AIRC method of section 41(c)(4) (available for years beginning on or before December 31, 2008), or the ASC method of section 41(c)(5)) and at least two members of the group qualify as the designated member, then the term *designated member* means that member that computes the group credit using the method that yields the greatest group credit. For example, A, B, C, and D are members of a controlled group but are not members of a consolidated group. For the 2008 taxable year (the credit year), the group credit using the method described in section 41(a)(1) is $10x. Under this method, A would be allocated $5x of the group credit, which would be the largest share of the group credit under this method. For the credit year, the group credit using the AIRC method is $15x. Under the AIRC method, B would be allocated $5x of the group credit, which is the largest share of the group credit computed using the AIRC method. For the credit year, the group credit using the ASC method is $10x. Under the ASC method, C would be allocated $5x of the group credit, which is the largest share of the group credit computed using the ASC method. Because the group credit is greatest using the AIRC method and B is allocated the greatest amount of credit under that method, B is the designated member. Therefore, if B makes a section 41(c)(4) election on its original timely filed return for the credit year, that election is binding on all members of the group for the credit year.

(5) *Effective/applicability dates.* This section is applicable for taxable years ending after *June 9, 2011.* For taxable years ending on or before *June 9, 2011,* see §§ 1.41–8 and 1.41–8T, as contained in 26 CFR part 1, revised April 1, 2011.

[T.D. 9296, 71 FR 65732, Nov. 9, 2006; 71 FR 70875, Dec. 7, 2006, as amended by T.D. 9401, 73 FR 34189, June 17, 2008; T.D. 9528, 76 FR 33996, June 10, 2011]

§ 1.41–9 Alternative simplified credit.

(a) *Determination of credit.* At the election of the taxpayer, the credit determined under section 41(a)(1) equals the amount determined under section 41(c)(5).

(b) *Election*—(1) *In general.* A taxpayer may elect to apply the provisions of the alternative simplified credit (ASC) in section 41(c)(5) for any taxable year of the taxpayer ending after December 31, 2006. If a taxpayer makes an election under section 41(c)(5), the election applies to the taxable year for which made and all subsequent taxable years unless revoked in the manner prescribed in paragraph (b)(3) of this section.

(2) *Time and manner of election.* A taxpayer makes an election under section 41(c)(5) by completing the portion of Form 6765, ''Credit for Increasing Research Activities,'' (or successor form) relating to the election of the ASC, and attaching the completed form to the taxpayer's timely filed (including extensions) original return for the taxable year to which the election applies. A taxpayer may make an election under section 41(c)(5) for a tax year on an amended return, but only if the taxpayer has not previously claimed a section 41(a)(1) credit on its original return or an amended return for that tax year, and only if that tax year is not closed by the period of limitations on assessment under section 6501(a). An extension of time to make an election under section 41(c)(5) will not be granted under § 301.9100–3 of this chapter. A taxpayer that is a member of a controlled group in a tax year may not make an election under section 41(c)(5) for that tax year on an amended return if any member of the controlled group for that tax year previously claimed the research credit under section 41(a)(1) using a method other than the ASC on an original or amended return for that tax year. See paragraph (b)(4) of this section for additional rules concerning controlled groups. See also § 1.41–6(b)(1) requiring that all members of the controlled group use the same method of computation.

(3) *Revocation.* An election under this section may not be revoked except with the consent of the Commissioner. A taxpayer is deemed to have requested, and to have been granted, the consent of the Commissioner to revoke an election under section 41(c)(5) if the taxpayer completes the portion of Form 6765 (or successor form) relating to the credit determined under section 41(a)(1) (the regular credit) or the alternative incremental credit (AIRC) and attaches the completed form to the taxpayer's timely filed (including extensions) original return for the year to which the revocation applies. An election under section 41(c)(5) may not be revoked on an amended return. An extension of time to revoke an election under section 41(c)(5) will not be granted under § 301.9100–3 of this chapter.

(4) *Special rules for controlled groups*—(i) *In general.* In the case of a controlled group of corporations, all the members of which are not included on a single consolidated return, an election (or revocation) must be made by the designated member by satisfying the requirements of paragraphs (b)(2) or (b)(3) of this section (whichever applies), and such election (or revocation) by the designated member shall be binding on all the members of the group for the credit year to which the election (or revocation) relates. If the designated member fails to timely make (or revoke) an election, each member of the group must compute the group credit using the method used to compute the group credit for the immediately preceding credit year.

(ii) *Designated member.* For purposes of this paragraph (b)(4), for any credit year, the term *designated member* means that member of the group that is allocated the greatest amount of the group credit under § 1.41–6(c) based on the amount of credit reported on the taxpayer's timely filed (including extensions) original Federal income tax return (even if that member subsequently is determined not to be the designated member). If the members of a group compute the group credit using different methods (the method described in section 41(a)(1), the AIRC method of section 41(c)(4), or the ASC method of section 41(c)(5)) and at least two members of the group qualify as the designated member, then the term *designated member* means that member that computes the group credit using the method that yields the greatest group credit. For example, A, B, C, and D are members of a controlled group but are not members of a consolidated group. For the 2011 taxable year (the credit year), the group credit using the method described in section 41(a)(1) is $10x. Under this method, A would be allocated $5x of the group credit, which would be the largest share of the group credit under this method. For the credit year, the group credit using the ASC method is $15x. Under the ASC method, C would be allocated $5x of the group credit, which is the largest share of the group credit computed using the ASC method. Because the group credit is greatest using the ASC method and C is allocated the greatest amount of credit under that method, C is the designated member. Therefore, if C makes a section 41(c)(5) election on its timely filed (including extensions) original return for the credit year, that election is binding on all members of the group for the credit year.

(c) *Special rules*—(1) *Qualified research expenses (QREs) required in all years.* Unless a taxpayer has QREs in each of the three taxable years preceding the taxable year for which the credit is being determined, the credit equals that percentage of the QREs for the taxable year provided by section 41(c)(5)(B)(ii).

(2) *Section 41(c)(6) applicability.* QREs for the three taxable years preceding the credit year must be determined on a basis consistent with the definition of QREs for the credit year, without regard to the law in effect for the three taxable years preceding the credit year. This consistency requirement applies even if the period for filing a claim for credit or refund has expired for any of the three taxable years preceding the credit year.

(3) *Short taxable years*—(i) *General rule.* If one or more of the three taxable years preceding the credit year is a short taxable year, then the QREs for such year are deemed to be equal to the QREs actually paid or incurred in that year multiplied by 365 and divided by the number of days in that year. If a credit year is a short taxable year, then the average QREs for the three taxable years preceding the credit year are modified by multiplying that amount by the number of days in the short taxable year and dividing the result by 365.

(ii) *Limited exception.* Returns filed for taxable years ending after December 31, 2006, and before June 9, 2011, and for which the period of limitations has not expired, may be amended to apply the daily calculation for short taxable years provided in paragraph (3)(i) of this section in lieu of the monthly calculation for short taxable years provided in §1.41–9T(c)(4).

(4) *Controlled groups.* For purposes of computing the group credit under §1.41–6, a controlled group must apply the rules of this paragraph (c) on an aggregate basis. For example, if the controlled group has QREs in each of the three taxable years preceding the taxable year for which the credit is being determined, the controlled group applies the credit computation provided by section 41(c)(5)(A) rather than section 41(c)(5)(B)(ii).

(d) *Effective/applicability dates.* This section is applicable for taxable years ending after June 9, 2011. For taxable years ending on or before June 9, 2011, see §1.41–9T as contained in 26 CFR part 1, revised April 1, 2011. Paragraph (b)(2) of this section applies to elections with respect to taxable years ending on or after February 27, 2015. For taxable years ending before *February 27, 2015*, see §1.41–9T as contained in 26 CFR part 1, revised April 1, 2015.

[T.D. 9528, 76 FR 33996, June 10, 2011, as amended by T.D. 9666, 79 FR 31864, June 3, 2014; T.D. 9712, 80 FR 10589, Feb. 27, 2015]

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This section lists the paragraphs contained in §§1.42–1 through 1.42–18 and §1.42–1T.

(5) Attachment to return
(e) Effective date of regulations

§ 1.42–3 Treatment of buildings financed with proceeds from a loan under an Affordable Housing Program established pursuant to section 721 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).

(a) Treatment under sections 42(i) and 42(b).
(b) Effective date.

§ 1.42–4 Application of not-for-profit rules of section 183 to low-income housing credit activities.

(a) Inapplicability to section 42.
(b) Limitation.
(c) Effective date.

§ 1.42–5 Monitoring compliance with low-income housing credit requirements.

(a) Compliance monitoring requirement.
(1) In general.
(2) Requirements for a monitoring procedure.
(i) In general.
(ii) Order and form.
(iii) [Reserved]
(b) Recordkeeping and record retention provisions.
(1) Recordkeeping provision.
(2) Record retention provision.
(3) Inspection record retention provision.
(c) Certification and review provisions.
(1) Certification.
(2) Review.
(ii)–(iii) [Reserved]
(3) [Reserved]
(4) Exception for certain buildings.
(i) In general.
(ii) Agreement and review.
(iii) Example.
(5) Agency reports of compliance monitoring activities.
(d) Inspection provision.
(1) In general.
(2) Inspection standard.
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(4) Delegation.
(e) Notification-of-noncompliance provisions.
(1) In general.
(2) Notice to owner.
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(ii) Agency retention of records.
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(1) Agencies permitted to delegate compliance monitoring functions.
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(2) Agencies permitted to delegate compliance monitoring functions to another Agency.
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§ 1.42–6 Buildings qualifying for carryover allocations.

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(b) Carryover-allocation basis.
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(ii) High cost areas.
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(c) Verification of basis by Agency.
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(d) Requirements for making carryover allocations.
(1) In general.
(2) Requirements for allocation.
(3) Special rules for project-based allocations.
(i) In general.
(ii) Requirement of section 42(h)(1)(F)(1)(III).
(4) Recordkeeping requirements.
(i) Taxpayer.
(ii) Agency.
(5) Separate procedure for election of appropriate percentage month.
(e) Special rules.
(1) Treatment of partnerships and other flow-through entities.
(2) Transferees.

§ 1.42–7 Substantially bond-financed buildings. [Reserved]

§ 1.42–8 Election of appropriate percentage month.

(a) Election under section 42(b)(2)(A)(ii)(I) to use the appropriate percentage for the month of a binding agreement.
(1) In general.
(2) Effect on state housing credit ceiling.
(3) Time and manner of making election.
(4) Multiple agreements.
(i) Rescinded agreements.
(ii) Increases in credit.
(5) Amount allocated.
(6) Procedures.
(i) Taxpayer.
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(7) Examples.
(b) Election under section 42(b)(2)(A)(ii)(II) to use the appropriate percentage for the month tax-exempt bonds are issued.
(1) Time and manner of making election.
(2) Bonds issued in more than one month.

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§ 1.42–9 For use by the general public.

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(D) HUD Utility Schedule Model.
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(2) Continual or frequent services.
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§ 1.42–12 Effective dates and transitional rules.

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(3) Electronic filing simplification changes.
(4) Utility allowances.
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§ 1.42–13 Rules necessary and appropriate; housing credit agencies' correction of administrative errors and omissions.

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§ 1.42–14 Allocation rules for post-2000 State housing credit ceiling amount.

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(i) Taxpayer notification.
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(f) When the State housing credit ceiling is determined.
(g) Stacking order.
(h) Nonprofit set-aside.
(1) Determination of set-aside.
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(i) National Pool.
(1) In general.
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[T.D. 8302, 55 FR 21189, May 23, 1990, as amended by T.D. 9755, 81 FR 11107, Mar. 3, 2016]

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This section lists the paragraphs contained in §§ 1.42–5T and 1.42–10T.

[T.D. 9755, 81 FR 11109, Mar. 3, 2016]

§ 1.42–1 Limitation on low-income housing credit allowed with respect to qualified low-income buildings receiving housing credit allocations from a State or local housing credit agency.

(a)–(g) [Reserved]. For further guidance, *see* § 1.42–1T(a) through (g).

(h) *Filing of forms.* Unless otherwise provided in forms or instructions, a completed Form 8586, ''Low-Income Housing Credit,'' (or any successor form) must be filed with the owner's Federal income tax return for each taxable year the owner of a qualified low-income building is claiming the low-income housing credit under section 42(a). Unless otherwise provided in forms or instructions, a completed

Form 8609, ''Low-Income Housing Credit Allocation and Certification,'' (or any successor form) must be filed by the building owner with the IRS. The requirements for completing and filing Forms 8586 and 8609 are addressed in the instructions to the forms.

(i) [Reserved]. For further guidance, *see* §1.42–1T(i).

(j) *Effective dates.* Section 1.42–1(h) applies to forms filed on or after November 7, 2005. The rules that apply for forms filed before November 7, 2005 are contained in §1.42–1T(h) and §1.42–1(h) (see 26 CFR part 1 revised as of April 1, 2003, and April 1, 2005).

[T.D. 9112, 69 FR 3827, Jan. 27, 2004, as amended by T.D. 9228, 70 FR 67356, Nov. 7, 2005]

§ 1.42–1T Limitation on low-income housing credit allowed with respect to qualified low-income buildings receiving housing credit allocations from a State or local housing credit agency (temporary).

(a) *In general*—(1) *Determination of amount of low-income housing credit.* Section 42 provides that, for purposes of section 38, a low-income housing credit is determined for a building in an amount equal to the applicable percentage of the qualified basis of the qualified low-income building. In general, the credit may be claimed annually for a 10–year credit period, beginning with the taxable year in which the building is placed in service or, at the election of the taxpayer, the succeeding taxable year. If, after the first year of the credit period, the qualified basis of a building is increased in excess of the qualified basis upon which the credit was initially determined, the allowable credit with respect to such additional qualified basis is determined using a credit percentage equal to two-thirds of the applicable percentage for the initial qualified basis. The credit for additions to qualified basis is generally allowable for the remaining years in the 15-year compliance period which begins with the first taxable year of the credit period for the building. In general, the low-income housing credit is available with respect to buildings placed in service after December 31, 1986, in taxable years ending after that date. *See* section 42 for the definitions of ''qualified low-income building'', ''applicable percentage'', ''qualified basis'', ''credit period'', ''compliance period'', and for other rules relating to determination of the amount of the low-income housing credit.

(2) *Limitation on low-income housing credit allowed.* Generally, the low-income housing credit determined under section 42 is allowed and may be claimed for any taxable year if, and to the extent that, the owner of a qualified low-income building receives a housing credit allocation from a State or local housing credit agency. The aggregate amount of housing credit allocations that may be made in any calendar year by all housing credit agencies within a State is limited by a State housing credit ceiling, or volume cap, described in paragraph (b) of this section. The authority to make housing credit allocations within the State housing credit ceiling may be apportioned among the State and local housing credit agencies, under the rules prescribed in paragraph (c) of this section. Upon apportionment of the State housing credit volume cap, each State or local housing credit agency receives an aggregate housing credit dollar amount that may be used to make housing credit allocations among qualified low-income buildings located within an agency's geographic jurisdiction. The rules governing the making of housing credit allocations by any state or local housing credit agency are provided in paragraph (d) of this section. Housing credit allocations are required to be taken into account by owners of qualified low-income buildings under the rules prescribed in paragraph (e) of this section. Exceptions to the requirement that a qualified low-income building receive a housing credit allocation from a State or local housing credit agency are provided in paragraph (f) of this section. Rules regarding termination of the authority of State and local housing credit agencies to make housing credit allocations after December 31, 1989, are specified in paragraph (g) of this section. Rules concerning information reporting by State and local housing credit agencies and owners of qualified low-income buildings are provided in paragraph (h)

of this section. Special statutory transitional rules are incorporated into this section of the regulations as described in paragraph (i) of this section.

(b) *The State housing credit ceiling.* The aggregate amount of housing credit allocations that may be made in any calendar year by all State and local housing credit agencies within a State may not exceed the State's housing credit ceiling for such calendar year. The State housing credit ceiling for each State for any calendar year is equal to $1.25 multiplied by the State's population. A State's population for any calendar year is determined by reference to the most recent census estimate (whether final or provisional) of the resident population of the State released by the Bureau of the Census before the beginning of the calendar year for which the State's housing credit ceiling is set. Unless otherwise prescribed by applicable revenue procedure, determinations of population are based on the most recent estimates of population contained in the Bureau of the Census publication, ''Current Population Reports, Series P–25: Population Estimates and Projections, Estimates of the Population of States''. For purposes of this section, the District of Columbia and United States possessions are treated as States.

(c) *Apportionment of State housing credit ceiling among State and local housing credit agencies*—(1) *In general.* A State's housing credit ceiling for any calendar year is apportioned among the State and local housing credit agencies within such State under the rules prescribed in this paragraph. A ''State housing credit agency'' is any State agency specifically authorized by gubernatorial act or State statute to make housing credit allocations on behalf of the State and to carry out the provisions of section 42(h). A ''local housing credit agency'' is any agency of a political subdivision of the State that is specifically authorized by a State enabling act to make housing credit allocations on behalf of the State or political subdivision and to carry out the provisions of section 42(h). A ''State enabling act'' is any gubernatorial act, State statute, or State housing credit agency regulation (if authorized by gubernatorial act or State statute). A State enabling act enacted on or before October 22, 1986, the date of enactment of the Tax Reform Act of 1986, shall be given effect for purposes of this paragraph if such State enabling act expressly carries out the provisions of section 42(h).

(2) *Primary apportionment.* Except as otherwise provided in paragraphs (c) (3) and (4) of this section, a State's housing credit ceiling is apportioned in its entirety to the State housing credit agency. Such an apportionment is the ''primary apportionment'' of a State's housing credit ceiling. There shall be no primary apportionment of the State housing credit ceiling and no grants of housing credit allocations in such State until a State housing credit agency is authorized by gubernatorial act or State statute. If a State has more than one State housing credit agency, such agencies shall be treated as a single agency for purposes of the primary apportionment. In such a case, the State housing credit ceiling may be divided among the multiple State housing credit agencies pursuant to gubernatorial act or State statute.

(3) *States with 1 or more constitutional home rule cities*—(i) *In general.* Notwithstanding paragraph (c)(2) of this section, in any State with 1 or more constitutional home rule cities, a portion of the State housing credit ceiling is apportioned to each constitutional home rule city. In such a State, except as provided in paragraph (c)(4) of this section, the remainder of the State housing credit ceiling is apportioned to the State housing credit agency under paragraph (c)(2) of this section. *See* paragraph (c)(3)(iii) of this section. The term ''constitutional home rule city'' means, with respect to any calendar year, any political subdivision of a State that, under a State constitution that was adopted in 1970 and effective on July 1, 1971, had home rule powers on the first day of the calendar year.

(ii) *Amount of apportionment to a constitutional home rule city.* The amount of the State housing credit ceiling apportioned to a constitutional home rule city for any calendar year is an amount that bears the same ratio to the State housing credit ceiling for that year as the population of the constitutional home rule city bears to the population of the entire State. The population of any constitutional home rule city for any calendar year is determined by reference to the most recent census estimate (whether final or provisional) of the resident population of the constitutional home rule city released by the Bureau of the Census before the beginning of the calendar year for which the State housing credit ceiling is apportioned. However, determinations of the population of a constitutional home rule city may not be based on Bureau of the Census estimates that do not contain estimates for all of the constitutional home rule cities within the State. If no Bureau of the Census estimate is available for all such constitutional home rule cities, the most recent decennial census of population shall be relied on. Unless otherwise prescribed by applicable revenue procedure, determinations of population for constitutional home rule cities are based on estimates of population contained in the Bureau of the Census publication, ''Current Population Reports, Series P–26: Local Population Estimates''.

(iii) *Effect of apportionments to constitutional home rule cities on apportionments to other housing credit agencies.* The aggregate amounts of the State housing credit ceiling apportioned to constitutional home rule cities under this paragraph (c)(3) reduce the State housing credit ceiling available for apportionment under paragraph (c) (2) or (4) of this section. Unless otherwise provided in a State constitutional amendment or by law changing the home rule provisions adopted in a manner provided by the State constitution, the power of the governor or State legislature to apportion the State housing credit ceiling among local housing credit agencies under paragraph (c)(4) of this section shall not be construed as allowing any reduction of the portion of the State housing credit ceiling apportioned to a constitutional home rule city under this paragraph (c)(3). However, any constitutional home rule city may agree to a reduction in its apportionment of the State housing credit ceiling under this paragraph (c)(3), in which case the amount of the State housing credit ceiling not apportioned to the constitutional home rule city shall be available for apportionment under paragraph (c) (2) or (4) of this section.

(iv) *Treatment of governmental authority within constitutional home rule city.* For purposes of determining which agency within a constitutional home rule city receives the apportionment of the State housing credit ceiling under this paragraph (c)(3), the rules of this paragraph (c) shall be applied by treating the constitutional home rule city as a ''State'', the chief executive officer of a constitutional home rule city as a ''governor'', and a city council as a ''State legislature''. A constitutional home rule city is also treated as a ''State'' for purposes of the set-aside requirement for housing credit allocations to projects involving a qualified nonprofit organization. *See* paragraph (c)(5) of this section for rules governing set-aside requirements. In this connection, a constitutional home rule city may agree with the State housing credit agency to exchange an apportionment set aside for projects involving a qualified nonprofit organization for an apportionment that is not so restricted. In such a case, the authorizing gubernatorial act, State statute, or State housing credit agency regulation (if authorized by gubernatorial act or State statute) must ensure that the set-aside apportionment transferred to the State housing credit agency be used for the purposes described in paragraph (c)(5) of this section.

(4) *Apportionment to local housing credit agencies*—(i) *In general.* In lieu of the primary apportionment under paragraph (c)(2) of this section, all or a portion of the State housing credit ceiling may be apportioned among housing credit agencies of governmental subdivisions. Apportionments of the State housing credit ceiling to local housing credit agencies must be made pursuant to a State enabling act as defined in paragraph (c)(1) of this section. Apportionments of the State housing credit ceiling may be made to housing credit agencies of constitutional home rule cities under this paragraph (c)(4), in addition to apportionments made under paragraph (c)(3) of this section. Apportionments of the State housing credit ceiling under this paragraph (c)(4) need

not be based on the population of political subdivisions and may, but are not required to, give balanced consideration to the low-income housing needs of the entire State.

(ii) *Change in apportionments during a calendar year.* The apportionment of the State housing credit ceiling among State and local housing credit agencies under this paragraph (c)(4) may be changed after the beginning of a calendar year, pursuant to a State enabling act. No change in apportionments shall retroactively reduce the housing credit allocations made by any agency during such year. Any change in the apportionment of the State housing credit ceiling under this paragraph (c)(4) that occurs during a calendar year is effective only to the extent housing credit agencies have not previously made housing credit allocations during such year from their original apportionments of the State housing credit ceiling for such year. To the extent apportionments of the State housing credit ceiling to local housing credit agencies made pursuant to this paragraph (c)(4) for any calendar year are not used by such local agencies before a certain date (e.g., November 1) to make housing credit allocations in such year, the amount of unused apportionments may revert back to the State housing credit agency for reapportionment. Such reversion must be specifically authorized by the State enabling act.

(iii) *Exchanges of apportionments.* Any State or local housing credit agency that receives an apportionment of the State housing credit ceiling for any calendar year under this paragraph (c)(4) may exchange part or all of such apportionment with another State or local housing credit agency to the extent no housing credit allocations have been made in such year from the exchanged portions. Such exchanges must be made with another housing credit agency in the same State and must be consistent with the State enabling act. If an apportionment set aside for projects involving a qualified nonprofit organization is transferred or exchanged, the transferee housing credit agency shall be required to use the set-aside apportionment for the purposes described in paragraph (c)(5) of this section.

(iv) *Written records of apportionments.* All apportionments, exchanges of apportionments, and reapportionments of the State housing credit ceiling which are authorized by this paragraph (c)(4) must be evidenced in the written records maintained by each State and local housing credit agency.

(5) *Set-aside apportionments for projects involving a qualified nonprofit organization*—(i) *In general.* Ten percent of the State housing credit ceiling for a calendar year must be set aside exclusively for projects involving a qualified nonprofit organization (as defined in paragraph (c)(5)(ii) of this section). Thus, at least 10 percent of apportionments of the State housing credit ceiling under paragraphs (c) (2) and (3) of this section must be used only to make housing credit allocations to buildings that are part of projects involving a qualified nonprofit organization. In the case of apportionments of the State housing credit ceiling under paragraph (c)(4) of this section, the State enabling act must ensure that the apportionment of at least 10 percent of the State housing credit ceiling be used exclusively to make housing credit allocations to buildings that are part of projects involving a qualified nonprofit organization. The State enabling act shall prescribe which housing credit agencies in the State receive apportionments that must be set aside for making housing credit allocations to buildings that are part of projects involving a qualified nonprofit organization. These set-aside apportionments may be distributed disproportionately among the State or local housing credit agencies receiving apportionments under paragraph (c)(4) of this section. The 10-percent set-aside requirement of this paragraph (c)(4) is a minimum requirement, and the State enabling act may set aside more than 10 percent of the State housing credit ceiling for apportionment to housing credit agencies for exclusive use in making housing credit allocations to buildings that are part of projects involving a qualified nonprofit organization.

(ii) *Projects involving a qualified nonprofit organization.* The term ‘‘projects involving a qualified nonprofit organization'' means projects with respect to which a qualified nonprofit organization is to materially participate (within the meaning of section 469(h)) in the development and continuing operation of the project throughout the 15-year compliance period. The term ''qualified nonprofit organization'' means any organization that is described in section 501(c) (3) or (4), is exempt from tax under section 501(a), and includes as one of its exempt purposes the fostering of low-income housing.

(6) *Expiration of unused apportionments.* Apportionments of the State housing credit ceiling under this paragraph (c) for any calendar year may be used by housing credit agencies to make housing credit allocations only in such calendar year. Any part of an apportionment of the State housing credit ceiling for any calendar year that is not used for housing credit allocations in such year expires as of the end of such year and does not carry over to any other year. However, any part of an apportionment for 1989 that is not used to make a housing credit allocation in 1989 may be carried over to 1990 and used to make a housing credit allocation to a qualified low-income building described in section 42(n)(2)(B). *See* paragraph (g)(2) of this section.

(d) *Housing credit allocations made by State and local housing credit agencies*—(1) *In general.* This paragraph governs State and local housing credit agencies in making housing credit allocations to qualified low-income buildings. The amount of the apportionment of the State housing credit ceiling for any calendar year received by any State or local housing credit agency under paragraph (c) of this section constitutes the agency's aggregate housing credit dollar amount for such year. The aggregate amount of housing credit allocations made in any calendar year by a State or local housing credit agency may not exceed such agency's aggregate housing credit dollar amount for such year. A State or local housing credit agency may make housing credit allocations only to qualified low-income buildings located within the agency's geographic jurisdiction.

(2) *Amount of a housing credit allocation.* In making a housing credit allocation, a State or local housing credit agency must specify a credit percentage, not to exceed the building's applicable percentage determined under section 42(b), and a qualified basis amount. The amount of the housing credit allocation for any building is the product of the specified credit percentage and the specified qualified basis amount. In specifying the credit percentage and qualified basis amount, the State or local housing credit agency shall not take account of the first-year conventions described in section 42(f) (2)(A) and (3)(B). A State or local housing credit agency may adopt rules or regulations governing conditions for specification of less than the maximum credit percentage and qualified basis amount allowable under section 42 (b) and (c), respectively. For example, an agency may specify a credit percentage and a qualified basis amount of less than the maximum credit percentage and qualified basis amount allowable under section 42 (b) and (c), respectively, when the financing and rental assistance from all sources for the project of which the building is a part is sufficient to provide the continuing operation of the building without the maximum credit amount allowable under section 42.

(3) *Counting housing credit allocations against an agency's aggregate housing credit dollar amount.* The aggregate amount of housing credit allocations made in any calendar year by a State or local housing credit agency may not exceed such agency's aggregate housing credit dollar amount (*i.e.*, the agency's apportionment of the State housing credit ceiling for such year). This limitation on the aggregate dollar amount of housing credit allocations shall be computed separately for set-aside apportionments received pursuant to paragraph (c)(5) of this section. Housing credit allocations count against an agency's aggregate housing credit dollar amount without regard to the amount of credit allowable to or claimed by an owner of a building in the taxable year in which the allocation is made or in any subsequent year. Thus, housing credit allocations (which are computed without regard to the

first-year conventions as provided in paragraph (d)(2) of this section) count in full against an agency's aggregate housing credit dollar amount, even though the first-year conventions described in section 42(f) (2)(A) and (3)(B) may reduce the amount of credit claimed by a taxpayer in the first year in which a credit is allowable. *See also* paragraph (e)(2) of this section. Housing credit allocations count against an agency's aggregate housing credit dollar amount only in the calendar year in which made and not in subsequent taxable years in the credit period or compliance period during which a taxpayer may claim a credit based on the original housing credit allocation. Since the aggregate amount of housing credit allocations made in any calendar year by a State or local housing credit agency may not exceed such agency's aggregate housing credit dollar amount, an agency shall at all times during a calendar year maintain a record of its cumulative allocations made during such year and its remaining unused aggregate housing credit dollar amount.

(4) *Rules for when applications for housing credit allocations exceed an agency's aggregate housing credit dollar amount.* A State or local housing credit agency may adopt rules or regulations governing the awarding of housing credit allocations when an agency expects that applicants during a calendar year will seek aggregate allocations in excess of the agency's aggregate housing credit dollar amount. The State enabling act may provide uniform standards for the awarding of housing credit allocations when there is actual or anticipated excess demand from applicants in any calendar year.

(5) *Reduced or additional housing credit allocations*—(i) *In general.* A State or local housing credit agency may not reduce or rescind a housing credit allocation made to a qualified low-income building in the manner prescribed in paragraph (d)(8) of this section. Thus, a housing credit agency may not reduce or rescind a housing credit allocation made to a qualified low-income building which is acquired by a new owner who is entitled to a carryover of the allowable credit for such building under section 42(d)(7). A housing credit agency may make additional housing credit allocations to a building in any year in the building's compliance period, whether or not there are additions to qualified basis for which an increased credit is allowable under section 42(f)(3). Each additional housing credit allocation made to a building is treated as a separate allocation and is subject to the rules and requirements of this section. However, in the case of an additional housing credit allocation made with respect to additions to qualified basis for which an increased credit is allowable under section 42(f)(3), the amount of the allocation that counts against the agency's aggregate housing credit dollar amount shall be computed as if the specified credit percentage were unreduced in the manner prescribed in section 42(f)(3)(A) and the specified qualified basis amount were unreduced by the first-year convention prescribed in section 42(f)(3)(B).

(ii) *Examples.* The rules of paragraph (d)(5)(i) of this section may be illustrated by the following examples:

Example 1. For 1987, the County L Housing Credit Agency has an aggregate housing credit dollar amount of $2 million. D, an individual, places in service on July 1, 1987, a new qualified low-income building. As of the close of each month in 1987 in which the building is in service, the building consists of 100 residential rental units, of which 20 units are both rent-restricted and occupied by individuals whose income is 50 percent or less of area median gross income. The total floor space of the residential rental units is 120,000 square feet, and the total floor space of the low-income units is 20,000 square feet. The building is not Federally subsidized within the meaning of section 42(i)(2). As of the end of 1987, the building has eligible basis under section 42(d) of $1 million. Thus, the qualified basis of the building determined without regard to the first-year convention provided in section 42(f) is $166,666.67 (*i.e.*, $1 million eligible basis times $\frac{1}{6}$, the floor space fraction which is required to be used instead of the larger unit fraction). However, the amount of the low-income housing credit determined for 1987 under section 42 reflects the first-year convention provided in section 42(f)(2). Since the building has the same floor space and unit fractions as of the close of each of the six months in 1987 during which it is in service, upon applying the first-year convention in section 42(f)(2), the qualified basis of the building in 1987 is $83,333.33 (*i.e.*, $1 million eligible basis times $\frac{1}{12}$, the fraction determined under section 42(f)(2)(A)). Under paragraph (d)(2) of this section, the

County L Housing Credit Agency may make a housing credit allocation by specifying a credit percentage, not to exceed 9 percent, and a qualified basis amount, which may be greater or less than the qualified basis of the building in 1987 as determined under section 42(c), without regard to the first-year convention provided in section 42(f)(2). If the County L Housing Credit Agency specifies a credit percentage of 8 percent and a qualified basis amount of $100,000, the amount of the housing credit allocation is $8,000. Under paragraph (d)(3) of this section, the County L Housing Credit Agency's aggregate housing credit dollar amount for 1987 is reduced by $8,000, notwithstanding that D is entitled to claim less than $8,000 of the credit in 1987 under the rules in paragraph (e) of this section. Under paragraph (e)(2) of this section, in 1987 D is entitled to claim only $4,000 of the credit, determined by applying the first-year convention of $6/12$ to the specified qualified basis amount contained in the housing credit allocation (*i.e.,* $.08 \times \$100{,}000 \times (6/12)$).

Example 2. The facts are the same as in *Example 1* except that on July 1, 1988, the number of occupied low-income units increases to 50 units and the floor space of the occupied low-income units increases to 48,000 square feet. These occupancy fractions remain unchanged as of the close of each month remaining in 1988. Under section 42(c), the qualified basis of the building in 1988, without regard to the first-year convention in section 42(f)(3)(B), is $400,000 (*i.e.,* $1 million eligible basis times .4, the floor space fraction which is required to be used instead of the larger unit fraction). D's 1987 housing credit allocation from the County L Housing Credit Agency remains effective in 1988 and entitles D to a credit of $8,000 (*i.e.,* .08, the specified credit percentage, times $100,000, the specified qualified basis amount). With respect to the additional $300,000 of qualified basis which the 1987 housing credit allocation does not cover, D must apply to the County L Housing Credit Agency for an additional housing credit allocation. Assume that the County L Housing Credit Agency has a sufficient aggregate housing credit dollar amount for 1988 to make a housing credit allocation to D in 1988 by specifying a credit percentage of 9 percent and a qualified basis amount of $300,000. The amount of the housing credit allocation that counts against the County L Housing Credit Agency's aggregate housing credit dollar amount is $27,000 (*i.e.,* the amount counted (.09 times $300,000) is unreduced in the manner prescribed in section 42(f)(3) (A) and (B)). Since D's qualified basis in 1987 was $166,666.67, D is entitled to claim a credit in 1988 with respect to such basis of $14,000 (*i.e.,* $.08 \times \$100{,}000$, the 1987 credit allocation, + $.09 \times \$66{,}666.67$, the 1988 credit allocation). In addition, D is entitled to claim a credit in 1988 and subsequent years in the 15-year compliance period with respect to the additional $233,333.33 of qualified basis covered by the 1988 housing credit allocation. However, the allowable credit for 1988 with respect to this amount of additional qualified basis is subject to reductions prescribed in section 42(f)(3) (A) and (B). Thus, D is entitled in 1988 to a credit at a 6-percent rate applied to $116,666.67 of additional qualified basis, which is reduced to reflect the first-year convention. D's total allowable low-income housing credit in 1988 is $21,000 (*i.e.,* $14,000 with respect to original qualified basis + $7,000 with respect to 1988 additions to qualified basis). If the County L Housing Credit Agency had specified an 8-percent credit percentage in 1988 with respect to the qualified basis not covered by the 1987 housing credit allocation to D, D's allowable credit with respect to the $233,333.33 of additions to qualified basis would not exceed, in 1988 and subsequent years, an amount determined by applying a specified credit percentage of 5.33 percent (*i.e.,* two-thirds of 8 percent). In 1988, D's specified qualified basis amount would be adjusted for the first-year convention.

(6) *No carryover of unused aggregate housing credit dollar amount.* Any portion of a State or local housing credit agency's aggregate housing credit dollar amount for any calendar year that is not used to make a housing credit allocation in such year may not be carried over to any other year, except as provided in paragraph (g) of this section. An agency may not permit owners of qualified low-income buildings to transfer housing credit allocations to other buildings. However, an agency may provide a procedure whereby owners may return to the agency, prior to the end of the calendar year in which housing credit allocations are made, unusable portions of such allocations. In such a case, an owner's housing credit allocation is deemed reduced by the amount of the allocation returned to the agency, and the agency may reallocate such amount to other qualified low-income buildings prior to the end of the year.

(7) *Effect of housing credit allocations in excess of an agency's aggregate housing credit dollar amount.* In the event that a State or local housing credit agency makes housing credit allocations in excess of its aggregate housing credit dollar amount for any calendar year, the allocations shall be deemed reduced (to the extent of such excess) for buildings in the reverse order in

which such allocations were made during such year.

(8) *Time and manner for making housing credit allocations*—(i) *Time.* Housing credit allocations are effective for the calendar year in which made in the manner prescribed in paragraph (d)(8)(ii) of this section. A State or local housing credit agency may not make a housing credit allocation to a qualified low-income building prior to the calendar year in which such building is placed in service. An agency may adopt its own procedures for receiving applications for housing credit allocations from owners of qualified low-income buildings. An agency may provide a procedure for making, in advance of a building's being placed in service, a binding commitment (e.g., by contract, inducement, resolution, or other means) to make a housing credit allocation in the calendar year in which a qualified low-income building is placed in service or in a subsequent calendar year. Any advance commitment shall not constitute a housing credit allocation for purposes of this section.

(ii) *Manner.* Housing credit allocations are deemed made when part I of IRS Form 8609, Low-Income Housing Credit Allocation Certification, is completed and signed by an authorized official of the housing credit agency and mailed to the owner of the qualified low-income building. A copy of all completed (as to part I) Form 8609 allocations along with a single completed Form 8610, Annual Low-Income Housing Credit Agencies Report, must also be mailed to the Internal Revenue Service not later than the 28th day of the second calendar month after the close of the calendar year in which the housing credit was allocated to the qualified low-income building. Housing credit allocations to a qualified low-income building must be made on Form 8609 and must include—

(A) The address of the building;

(B) The name, address, and taxpayer identification number of the housing credit agency making the housing credit allocation;

(C) The name, address, and taxpayer identification number of the owner of the qualified low-income building;

(D) The date of the allocation of housing credit;

(E) The housing credit dollar amount allocated to the building on such date;

(F) The specified maximum applicable credit percentage allocated to the building on such date;

(G) The specified maximum qualified basis amount;

(H) The percentage of the aggregate basis financed by tax-exempt bonds taken into account for purposes of the volume cap under section 146;

(I) A certification under penalties of perjury by an authorized State or local housing credit agency official that the allocation is made in compliance with the requirements of section 42(h); and

(J) Any additional information that may be required by Form 8609 or by an applicable revenue procedure.

See paragraph (h) of this section for additional rules concerning filing of forms.

(iii) *Certification.* The certifying official for the State or local housing credit agency need not perform an independent investigation of the qualified low-income building in order to certify on part I of Form 8609 that the housing credit allocation meets the requirements of section 42(h). For example, the certifying official may rely on information contained in an application for a low-income housing credit allocation submitted by the building owner which sets forth facts necessary to determine that the building is eligible for the low-income housing credit under section 42.

(iv) *Fee.* A State or local housing credit agency may charge building owners applying for housing credit allocations a reasonable fee to cover the agency's administrative expenses for processing applications.

(v) *No continuing agency responsibility.* The State or local housing credit agency need not monitor or investigate the continued compliance of a qualified low-income building with the requirements of section 42 throughout the applicable compliance period.

(e) *Housing credit allocation taken into account by owner of a qualified low-income building*—(1) *Time and manner for taking housing credit allocation into account.* An owner of a qualified low-income building may not claim a low-income housing credit determined under section 42 in any year in excess of an effective housing credit allocation received from a State or local housing credit agency. A housing credit allocation made to a qualified low-income building is effective with respect to any owner of the building beginning with the owner's taxable year in which the housing credit allocation is received. A housing credit allocation is deemed received in a taxable year, except as modified in the succeeding sentence, if that allocation is made (in the manner described in paragraph (d)(8) of this section) not later than the earlier of (i) the 60th day after the close of the taxable year, or (ii) the close of the calendar year in which such taxable year ends. A housing credit allocation is deemed received in a taxable year ending in 1987, if such allocation is made (in the manner described in paragraph (d)(8) of this section) on or before December 31, 1987. A housing credit allocation is not effective for any taxable year if received in a calendar year which ends prior to when the qualified low-income building is placed in service. A housing credit allocation made to a qualified low-income building remains effective for all taxable years in the compliance period.

(2) *First-year convention limitation on housing credit allocation taken into account.* For purposes of the limitation that the allowable low-income housing credit may not exceed the effective housing credit allocation received from a State or local housing credit agency, as provided in paragraph (e)(1) of this section, the amount of the effective housing credit allocation shall be adjusted by applying the first-year convention provided in section 42(f)(2)(A) and (3)(B) and the percentage credit reduction provided in section 42(f)(3)(A). Under paragraphs (d) (2) and (5) of this section, the State or local housing credit agency must specify the credit percentage and qualified basis amount, the product of which is the amount of the housing credit allocation, without taking account of the first-year convention described in section 42(f)(2)(A) and (3)(B) or the percentage credit reduction prescribed in section 42(f)(3)(A). However, for purposes of the limitation on the amount of the allowable low-income housing credit, as provided in paragraph (e)(1) of this section, in a taxable year in which the first-year convention applies to the amount of credit determined under section 42(a), the specified qualified basis amount shall be adjusted by the first-year convention fraction which is equal to the number of full months (during the first taxable year) in which the building was in service divided by 12. In addition, for purposes of the limitation on the amount of the allowable low-income housing credit, as provided in paragraph (e)(1) of this section, in a taxable year in which the reduction in credit percentage applies to additions to qualified basis, as prescribed in section 42(f)(3), the specified credit percentage shall be reduced by one-third. *See* examples in paragraphs (d)(5)(ii) and (e)(3)(ii) of this section.

(3) *Use of excess housing credit allocation for increases in qualified basis*—(i) *In general.* If the housing credit allocation made to a qualified low-income building exceeds the amount of credit allowable with respect to such building in any taxable year (without regard to the first-year conventions under section 42(f)), such excess is not transferable to another qualified low-income building. However, if in a subsequent year there are increases in the qualified basis for which an increased credit is allowable under section 42(f)(3) at a reduced credit percentage, the original housing credit allocation (including the specified credit percentage and qualified basis amount) would be effective with respect to such increased credit.

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

Example. In 1987, a newly-constructed qualified low-income building receives a housing credit allocation of $90,000 based on a specified credit percentage of 9 percent and a specified qualified basis amount of $1,000,000. The building is placed in service in 1987, but the qualified basis in such year is only $800,000, resulting in an allowable credit in 1987 (determined without regard to the first-year conventions) of $72,000. In 1988, the qualified basis is increased to $1,100,000, resulting in an additional credit allowable under section 42(f)(3) (without regard to the first-year conventions) of $18,000 (*i.e.*, $300,000 × .06, or ⅔ of .09). The unused portion of the 1987 housing credit allocation ($18,000) is effective in 1988 and in each subsequent year in the compliance period only with respect to the specified qualified basis for the 1987 housing credit allocation ($1,000,000). Thus, the owner is allowed to claim a credit in 1988 and in each subsequent year (without regard to the first-year conventions), based on the effective housing credit allocation from 1987, of $84,000 (*i.e.*, $72,000 + ($200,000 × .06)). The owner of the qualified low-income building must obtain a new housing credit allocation in 1988 with respect to the additional $100,000 of qualified basis in order to claim a credit on such basis in 1988 and in each subsequent year. If the applicable first-year convention under section 42(f)(3)(B) entitled the owner in 1988 to only ½ of the otherwise applicable credit for the additions to qualified basis, under paragraph (e)(2) of this section the owner is allowed to claim a credit in 1988, based on the effective housing credit allocation from 1987, of $78,000 (*i.e.*, $72,000 + ($200,000 × .06 × .5)).

(4) *Separate housing credit allocations for new buildings and increases in qualified basis.* Separate housing credit allocations must be received for each building with respect to which a housing credit may be claimed. Rehabilitation expenditures with respect to a qualified low-income building are treated as a separate new building under section 42(e) and must receive a separate housing credit allocation. Increases in qualified basis in a qualified low-income building are not generally treated as a new building for purposes of section 42. To the extent that a prior housing credit allocation received with respect to a qualified low-income building does not allow an increased credit with respect to an increase in the qualified basis of such building, an additional housing credit allocation must be received in order to claim a credit with respect to that portion of increase in qualified basis. *See* paragraph (e)(3) of this section. The amount of credit allowable with respect to an increase in qualified basis is subject to the credit percentage limitation of section 42(f)(3)(A) and the first-year convention of section 42(f)(3)(B). *See* paragraph (d)(5) of this section for a rule requiring that the State or local housing credit agency count a housing credit allocation made with respect to an increase in qualified basis as if the specified credit percentage were unreduced in the manner prescribed in section 42(f)(3) and the specified basis amount were unreduced by the first-year convention prescribed in section 42(f)(3)(B).

(5) *Acquisition of building for which a prior housing credit allocation has been made.* If a carryover credit would be allowable to an acquirer of a qualified low-income building under section 42(d)(7), such acquirer need not obtain a new housing credit allocation with respect to such building. Under section 42(d)(7), the acquirer would be entitled to claim only such credits as would have been allowable to the prior owner of the building.

(6) *Multiple housing credit allocations.* A qualified low-income building may receive multiple housing credit allocations from different housing credit agencies having overlapping jurisdictions. A qualified low-income building that receives a housing credit allocation set aside exclusively for projects involving a qualified nonprofit organization may also receive a housing credit allocation from a housing credit agency's aggregate housing credit dollar amount that is not so set aside.

(f) *Exception to housing credit allocation requirement*—(1) *Tax-exempt bond financing*—(i) *In general.* No housing credit allocation is required in order to claim a credit under section 42 with respect to that portion of the eligible basis (as defined in section 42(d)) of a qualified low-income building that is financed with the proceeds of an obligation described in section 103(a) (''tax-exempt bond'') which is taken into account for purposes of the volume cap under section 146. In addition, no housing credit allocation is required in order to claim a credit under section 42 with respect to the entire qualified basis (as defined in section 42(c)) of a qualified low-income building if 70 percent or more of the aggregate basis of the building and the land on which the building is located is financed with the proceeds of tax-exempt bonds which are taken into account for purposes of the volume cap under section 146. For purposes of this paragraph, ''land on which the building is located'' includes only land that is functionally related and subordinate to the qualified low-income building. *See* §1.103–8(b)(4)(iii) for the meaning of the term ''functionally related and subordinate''. For purposes of this paragraph, the basis of the land shall be determined using principles that are consistent with the rules contained in section 42(d).

(ii) *Determining use of bond proceeds.* For purposes of determining the portion of proceeds of an issue of tax-exempt bonds used to finance (A) the eligible basis of a qualified low-income building, and (B) the aggregate basis of the building and the land on which the building is located, the proceeds of the issue must be allocated in the bond indenture or a related document (as defined in §1.103–13(b)(8)) in a manner consistent with the method used to allocate the net proceeds of the issue for purposes of determining whether 95 percent or more of the net proceeds of the issue are to be used for the exempt purpose of the issue. If the issuer is not consistent in making this allocation throughout the bond indenture and related documents, or if neither the bond indenture nor a related document provides an allocation, the proceeds of the issue will be allocated on a pro rata basis to all of the property financed by the issue, based on the relative cost of the property.

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

Example. In 1987, County K assigns $500,000 of its volume cap for private activity bonds under section 146 to a $500,000 issue of exempt facility bonds to provide a qualified residential rental project to be owned by A, an individual. The aggregate basis of the building and the land on which the building is located is $700,000. Under the terms of the bond indenture, the net proceeds of the issue are to be used to finance $490,000 of the eligible basis of the building. More than 70 percent of the aggregate basis of the qualified low-income building and the land on which the building is located is financed with the proceeds of tax-exempt bonds to which a portion of the volume cap under section 146 was allocated. Accordingly, A may claim a credit under section 42 without regard to whether any housing credit dollar amount was allocated to that building. If, instead, the aggregate basis of the building and land were $800,000, A would be able to claim the credit under section 42 without receiving a housing credit allocation for the building only to the extent that the credit was attributable to eligible basis of the building financed with tax-exempt bonds.

(g) *Termination of authority to make housing credit allocation*—(1) *In general.* No State or local housing credit agency shall receive an apportionment of a State housing credit ceiling for calendar years after 1989. Consequently, no housing credit allocations may be made after 1989, except as provided in paragraph (g)(2) of this section. Housing credit allocations made prior to January 1, 1990, remain effective after such date.

(2) *Carryover of unused 1989 apportionment.* Any State or local housing credit agency that has an unused portion of its apportionment of the State housing credit ceiling for 1989 from which housing credit allocations have not been made in 1989 may carry over such unused portion into 1990. Such carryover portion of the 1989 apportionment shall be treated as the agency's apportionment for 1990. From this 1990 apportionment, the State or local housing credit agency may make housing credit allocations only to a qualified low-income building meeting the following requirements:

(i) The building must be constructed, reconstructed, or rehabilitated by the taxpayer seeking the allocation;

(ii) More than 10 percent of the reasonably anticipated cost of such construction, reconstruction, or rehabilitation must have been incurred as of January 1, 1989; and

(iii) The building must be placed in service before January 1, 1991.

(3) *Expiration of exception for tax-exempt bond financed projects.* The exception to the requirement that a housing credit allocation be received with respect to any portion of the eligible basis of a qualified low-income building, as provided in paragraph (f) of this section, shall not apply to any building placed in service after 1989, unless such building is described in paragraphs (g)(2) (i), (ii), and (iii) of this section.

(h) *Filing of forms.* For further guidance, *see* §1.42–1(h).

(i) *Transitional rules.* The transitional rules contained in section 252(f)(1) of the Tax Reform Act of 1986 are incorporated into this section of the regulations for purposes of determining whether a qualified low-income building is entitled to receive a housing credit allocation or is excepted from the requirement that a housing credit allocation be received. Housing credit allocations made to qualified low-income buildings described in section 252(f)(1) shall not count against the State or local housing credit agency's aggregate housing credit dollar amount. The transitional rules contained in section 252(f)(2) of the Tax Reform Act of 1986 are incorporated into this section of the regulations for purposes of determining amounts available to certain State or local housing credit agencies for the making of housing credit allocations to certain qualified low-income housing projects. Amounts available to housing credit agencies under section 252(f)(2) shall be treated as special apportionments unavailable for housing credit allocations to qualified low-income buildings not described in section 252(f)(2). Housing credit allocations made from the special apportionments shall not count against the State or local credit agency's aggregate housing credit dollar amount. The set-aside requirements shall not apply to these special apportionments. The transitional rules contained in section 252(f)(3) of the Tax Reform Act 1986 are incorporated in this section of the regulations for purposes of determining the amount of housing credit allocations received by certain qualified low-income buildings. Housing credit allocations deemed received under section 252(f)(3) shall not count against the State or local housing credit agency's aggregate housing credit dollar amount.

[T.D. 8144, 52 FR 23433, June 22, 1987; 52 FR 24583, July 1, 1987, as amended by T.D. 9112, 69 FR 3827, Jan. 27, 2004]

§ 1.42–2 Waiver of requirement that an existing building eligible for the low-income housing credit was last placed in service more than 10 years prior to acquisition by the taxpayer.

(a) *Low-income housing credit for existing building.* Section 42 provides that, for purposes of section 38, new and existing qualified low-income buildings are eligible for a low-income housing credit. The eligibility rules for new and existing buildings differ. Under section 42(d)(2), an existing building may be eligible for the low-income housing credit based upon the acquisition cost and amounts chargeable to capital account (to the extent properly included in eligible basis) if—

(1) The taxpayer acquires the building by purchase (as defined in section 179(d)(2), as applicable under section 42(d)(2)(D)(iii)(I)),

(2) There is a period of at least 10 years between the date of the building's acquisition by the taxpayer and the later of—(i) The date the building was last placed in service, or

(ii) The date of the most recent nonqualified substantial improvement of the building, and

(3) The building was not previously placed in service by the taxpayer, or by a person who was a related person (as defined in section 42(d)(2)(D)(iii)(II)) with respect to the taxpayer as of the time the building was last previously placed in service.

(b) *Waiver of 10-year holding period requirement.* Section 42(d)(6) provides that a taxpayer may apply for a waiver of the 10-year holding period requirement specified in paragraph (a)(2) of this section. The Internal Revenue Service will grant a waiver only if—

(1) The existing building satisfies all of the requirements in paragraph (c) of this section, and

(2) The taxpayer makes an application in conformity with the requirements in paragraph (d) of this section.

(c) *Waiver requirements*—(1) *Federally-assisted building.* To satisfy the requirement of this paragraph, a building must be a Federally-assisted building. The term ''Federally assisted building'' means any building which is substantially assisted, financed, or operated under section 8 of the United States Housing Act of 1937, section 221(d)(3) or 236 of the National Housing Act, or section 515 of the Housing Act of 1949, as such acts were in effect on October 22, 1986.

(2) *Federal mortgage funds at risk.* To satisfy the requirement of this paragraph, Federal mortgage funds must be at risk with respect to a mortgage that is secured by the building or a project of which the building is a part. For purposes of this paragraph, Federal mortgage funds are at risk if, in the event of a default by the mortgagor on the mortgage secured by the building or the project of which the building is a part—

(i) The mortgage could be assigned to the Department of Housing and Urban Development or the Farmers' Home Administration, or

(ii) There could arise a claim against a Federal mortgage insurance fund (or such Department or Administration).

(3) *Statement by the Department of Housing and Urban Development or the Farmers' Home Administration.* (i) To satisfy the requirement of this paragraph, a letter or other written statement must be made or received and approved by the national office of the Department of Housing and Urban Development or the Farmers' Home Administration (''the Federal agency''). This letter or statement shall include the following:

(A) A statement that, as of the earlier of the time of the taxpayer's acquisition of the building or the taxpayer's application for a waiver, the building is a Federally-assisted building within the meaning of paragraph (c)(1) of this section and identifies the source of Federal assistance;

(B) A statement that a waiver of the 10-year holding period requirement is necessary to avert Federal mortgage funds being at risk within the meaning of paragraph (c)(2) of this section; and

(C) A statement that the Federal agency has taken a Federal agency action as described in paragraph (c)(3)(ii) of this section.

(ii) The following specified Federal agency actions shall be the only means of satisfying the requirement of this paragraph:

(A) The Federal agency intends to accept an assignment of a mortgage secured by the building or the project of which the building is a part, and such assignment requires payments by the agency or a mortgage insurance fund maintained by the agency to the prior mortgagee;

(B) The Federal agency or a mortgage insurance fund maintained by the agency intends to accept, as a consequence of foreclosure proceedings or otherwise, conveyance of the building or the project of which the building is a part;

(C) The Federal agency or a mortgage insurance fund maintained by the agency intends, as a consequence of default, to take possession of, hold title to, or otherwise assume ownership of the building or the project of which the building is a part; or

(D) The Federal agency has designated the building or the project of which the building is a part as a troubled building or project. A designation of a troubled building or project must satisfy the following requirements:

(*1*) Designation of troubled status must be based on a review by the Federal agency of the financial condition of the building or project and on a determination by the Federal agency of a history of financial distress or mortgage defaults;

(*2*) Designation of troubled status must be made or received and approved by the national office of the Federal agency; and

(*3*) Federal agency regulations or procedures must provide that, in the event of transfer of the ownership of a designated troubled building or project, the building or project may be subject to continued review by the Federal agency. Each Federal agency may prescribe its own standards and procedures for designating a troubled building or project so long as such standards are consistent with the requirements of this paragraph (c)(3)(ii)(D).

(4) *No prior credit allowed.* The requirement of this paragraph is satisfied only if no prior owner was allowed a low-income housing credit under section 42 for the building.

(d) *Application for waiver*—(1) *Time and manner.* In order to receive a waiver of the 10-year holding period requirement specified in paragraph (a)(2) of this section, a taxpayer must file an application (including the applicable user fee) that complies with the requirements of this paragraph (d) and Rev. Proc. 90–1, 1990–1 I.R.B. 8 (or any subsequent applicable revenue procedure). The application must be filed by a taxpayer who has acquired the building by purchase or who has a binding contract to purchase the building. Such binding contract may be conditioned upon the granting of a waiver under this section. The application may be filed at any time after a binding contract has been entered into, but no later than 12 months after the taxpayer's acquisition of the building. An application for a waiver of the 10-year holding period requirement must not contain a request for a ruling on any other issue arising under section 42 or other sections of the Internal Revenue Code. An application for a waiver of the 10-year holding period requirement must be mailed or delivered to the address listed in section 3.01 of Rev. Proc. 90–1 (or any subsequent applicable revenue procedure).

(2) *Information required.* An application for a waiver of the 10-year holding period requirement must contain the following information:

(i) The taxpayer's name, address and taxpayer identification number;

(ii) The name (if any) and address of the acquired building and the project (if any) of which it is a part;

(iii) The date of acquisition or the date of the binding contract for acquisition of the building by the taxpayer and the expected date of acquisition, the amount of consideration paid or to be paid for the acquisition (including the value of any liabilities assumed by the taxpayer), and the taxpayer's certification that such acquisition is by purchase (as defined in section 179(d)(2), as applicable under section 42 (d)(2)(D)(iii)(I));

(iv) The identity of the person from whom the building is acquired, and whether such person is a Federal agency, a mortgagee holding title to the building, or the mortgagor or prior owner;

(v) The date the building was last placed in service and the date of the most recent (if any) nonqualified substantial improvement of the building (as defined in section 42 (d)(2)(D)(i));

(vi) The taxpayer's certification that the building was not previously placed in service by the taxpayer, or by a person who was a related person (as defined in section 42(d)(2)(D)(iii)(II)) with respect to the taxpayer as of the time the building was last placed in service;

(vii) The amount and disposition (e.g., discharge, assignment, assumption, or refinance) of the outstanding mortgage at the time of acquisition and the identities of the mortgagee and mortgagor;

(viii) The taxpayer's certification that no prior owner was allowed a low-income housing credit under section 42 for the building (made to the best of the taxpayer's knowledge, with no documentation from other persons needed to be submitted); and

(ix) The statement from the Federal agency required by paragraph (c)(3)(i) of this section.

(3) *Other rules.* (i) In the event that an acquired building will be owned by more than one taxpayer, a single application for waiver may be filed by one taxpayer on behalf of the co-owners if the application contains the names, addresses and taxpayer identification numbers of the other owners. A general partner or a designated limited partner may file an application for waiver on behalf of a partnership.

(ii) In the event that multiple Federally-assisted buildings in a project are being acquired by the taxpayer, a single application for waiver with respect to such buildings may be filed if the application contains the required information set out for the address of each Federally-assisted building involved.

(iii) In the event that specific Federally-assisted buildings are being acquired by the taxpayer in a project consisting of multiple buildings that may or may not be Federally-assisted, a single application for waiver with respect to the Federally-assisted buildings being acquired may be filed if the application contains the required information set out for the address of each Federally-assisted building being acquired.

(4) *Effective date of waiver.* A waiver will be effective when granted in writing by the Internal Revenue Service after submission of a completed application for waiver filed under this paragraph (d).

(5) *Attachment to return.* A waiver letter granted by the Internal Revenue Service shall be filed with the taxpayer's Federal income tax return for the first taxable year the low-income housing credit is claimed by the taxpayer.

(e) *Effective date of regulations.* The provisions of §1.42–2 are effective for buildings placed in service by the taxpayer after December 31, 1986.

[T.D. 8302, 55 FR 21189, May 23, 1990; 55 FR 25973, June 26, 1990]

§ 1.42–3 Treatment of buildings financed with proceeds from a loan under an Affordable Housing Program established pursuant to section 721 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).

(a) *Treatment under sections 42(i) and 42(b)*. A below market loan funded in whole or in part with funds from an Affordable Housing Program established under section 721 of FIRREA is not, solely by reason of the Affordable Housing Program funds, a below market Federal loan as defined in section 42(i)(2)(D). Thus, any building with respect to which the proceeds of the loan are used during the tax year is not, solely by reason of the Affordable Housing Program funds, treated as a federally subsidized building for that tax year and subsequent tax years for purposes of determining the applicable percentage for the building under section 42(b).

(b) *Effective date*. The rules set forth in paragraph (a) of this section are effective for loans made after August 8, 1989.

[56 FR 48734, Sept. 26, 1991]

§ 1.42–4 Application of not-for-profit rules of section 183 to low-income housing credit activities.

(a) *Inapplicability to section 42*. In the case of a qualified low-income building with respect to which the low-income housing credit under section 42 is allowable, section 183 does not apply to disallow losses, deductions, or credits attributable to the ownership and operation of the building.

(b) *Limitation*. Notwithstanding paragraph (a) of this section, losses, deductions, or credits attributable to the ownership and operation of a qualified low-income building with respect to which the low-income housing credit under section 42 is allowable may be limited or disallowed under other provisions of the Code or principles of tax law. See, e.g., sections 38(c), 163(d), 465, 469; *Knetsch* v. *United States*, 364 U.S. 361 (1960), 1961–1 C.B. 34 (''sham'' or ''economic substance'' analysis); and *Frank Lyon Co.* v. *Commissioner*, 435 U.S. 561 (1978), 1978–1 C.B. 46 (''ownership'' analysis).

(c) *Effective date*. The rules set forth in paragraphs (a) and (b) of this section are effective with respect to buildings placed in service after December 31, 1986.

[T.D. 8420, 57 FR 24729, June 11, 1992]

§ 1.42–5 Monitoring compliance with low-income housing credit requirements.

(a) *Compliance monitoring requirement*—(1) *In general*. Under section 42(m)(1)(B)(iii), an allocation plan is not qualified unless it contains a procedure that the State or local housing credit agency (''Agency'') (or an agent of, or other private contractor hired by, the Agency) will follow in monitoring for noncompliance with the provisions of section 42 and in notifying the Internal Revenue Service of any noncompliance of which the Agency becomes aware. These regulations only address compliance monitoring procedures required of Agencies. The regulations do not address forms and other records that may be required by the Service on examination or audit. For example, if a building is sold or otherwise transferred by the owner, the transferee should obtain from the transferor information related to the first year of the credit period so that the transferee can substantiate credits claimed.

(2) *Requirements for a monitoring procedure*—(i) *In general*. A procedure for monitoring for noncompliance under section 42(m)(1)(B)(iii) must include—

(A) The recordkeeping and record retention provisions of paragraph (b) of this section;

(B) The certification and review provisions of paragraph (c) of this section;

(C) The inspection provision of paragraph (d) of this section; and

(D) The notification-of-noncompliance provisions of paragraph (e) of this section.

(ii) *Order and form*. A monitoring procedure will meet the requirements of section 42 (m)(1)(B)(iii) if it contains the substance of these provisions. The particular order and form of the provisions in the allocation plan is not material. A monitoring procedure may contain additional provisions or requirements.

(iii) [Reserved]. For further guidance, see § 1.42–5T(a)(2)(iii).

(b) *Recordkeeping and record retention provisions*—(1) *Recordkeeping provision.* Under the recordkeeping provision, the owner of a low-income housing project must be required to keep records for each qualified low-income building in the project that show for each year in the compliance period—

(i) The total number of residential rental units in the building (including the number of bedrooms and the size in square feet of each residential rental unit);

(ii) The percentage of residential rental units in the building that are low-income units;

(iii) The rent charged on each residential rental unit in the building (including any utility allowances);

(iv) The number of occupants in each low-income unit, but only if rent is determined by the number of occupants in each unit under section 42(g)(2) (as in effect before the amendments made by the Omnibus Budget Reconciliation Act of 1989);

(v) The low-income unit vacancies in the building and information that shows when, and to whom, the next available units were rented;

(vi) The annual income certification of each low-income tenant per unit. For an exception to this requirement, see section 42(g)(8)(B) (which provides a special rule for a 100 percent low-income building);

(vii) Documentation to support each low-income tenant's income certification (for example, a copy of the tenant's federal income tax return, Forms W-2, or verifications of income from third parties such as employers or state agencies paying unemployment compensation). For an exception to this requirement, see section 42(g)(8)(B) (which provides a special rule for a 100 percent low-income building). Tenant income is calculated in a manner consistent with the determination of annual income under section 8 of the United States Housing Act of 1937 (''Section 8''), not in accordance with the determination of gross income for federal income tax liability. In the case of a tenant receiving housing assistance payments under Section 8, the documentation requirement of this paragraph (b)(1)(vii) is satisfied if the public housing authority provides a statement to the building owner declaring that the tenant's income does not exceed the applicable income limit under section 42 (g);

(viii) The eligible basis and qualified basis of the building at the end of the first year of the credit period; and

(ix) The character and use of the nonresidential portion of the building included in the building's eligible basis under section 42 (d) (e.g., tenant facilities that are available on a comparable basis to all tenants and for which no separate fee is charged for use of the facilities, or facilities reasonably required by the project).

(2) *Record retention provision.* Under the record retention provision, the owner of a low-income housing project must be required to retain the records described in paragraph (b)(1) of this section for at least 6 years after the due date (with extensions) for filing the federal income tax return for that year. The records for the first year of the credit period, however, must be retained for at least 6 years beyond the due date (with extensions) for filing the federal income tax return for the last year of the compliance period of the building.

(3) *Inspection record retention provision.* Under the inspection record retention provision, the owner of a low-income housing project must be required to retain the original local health, safety, or building code violation reports or notices that were issued by the State or local government unit (as described in paragraph (c)(1)(vi) of this section) for the Agency's inspection under paragraph (d) of this section. Retention of the original violation reports or notices is not required once the Agency reviews the violation reports or notices and completes its inspection, unless the violation remains uncorrected.

(c) *Certification and review provisions*—(1) *Certification.* Under the certification provision, the owner of a low-income housing project must be required to certify at least annually to the Agency that, for the preceding 12-month period—

(i) The project met the requirements of:

(A) The 20–50 test under section 42 (g)(1)(A), the 40–60 test under section 42 (g)(1)(B), or the 25–60 test under sections 42 (g)(4) and 142 (d)(6) for New York City, whichever minimum set-aside test was applicable to the project; and

(B) If applicable to the project, the 15–40 test under sections 42(g)(4) and 142 (d)(4)(B) for ''deep rent skewed'' projects;

(ii) There was no change in the applicable fraction (as defined in section 42(c)(1)(B)) of any building in the project, or that there was a change, and a description of the change;

(iii) The owner has received an annual income certification from each low-income tenant, and documentation to support that certification; or, in the case of a tenant receiving Section 8 housing assistance payments, the statement from a public housing authority described in paragraph (b)(1)(vii) of this section. For an exception to this requirement, see section 42(g)(8)(B) (which provides a special rule for a 100 percent low-income building);

(iv) Each low-income unit in the project was rent-restricted under section 42(g)(2);

(v) All units in the project were for use by the general public (as defined in §1.42–9), including the requirement that no finding of discrimination under the Fair Housing Act, 42 U.S.C. 3601–3619, occurred for the project. A finding of discrimination includes an adverse final decision by the Secretary of the Department of Housing and Urban Development (HUD), 24 CFR 180.680, an adverse final decision by a substantially equivalent state or local fair housing agency, 42 U.S.C. 3616a(a)(1), or an adverse judgment from a federal court;

(vi) The buildings and low-income units in the project were suitable for occupancy, taking into account local health, safety, and building codes (or other habitability standards), and the State or local government unit responsible for making local health, safety, or building code inspections did not issue a violation report for any building or low-income unit in the project. If a violation report or notice was issued by the governmental unit, the owner must attach a statement summarizing the violation report or notice or a copy of the violation report or notice to the annual certification submitted to the Agency under paragraph (c)(1) of this section. In addition, the owner must state whether the violation has been corrected;

(vii) There was no change in the eligible basis (as defined in section 42(d)) of any building in the project, or if there was a change, the nature of the change (e.g., a common area has become commercial space, or a fee is now charged for a tenant facility formerly provided without charge);

(viii) All tenant facilities included in the eligible basis under section 42(d) of any building in the project, such as swimming pools, other recreational facilities, and parking areas, were provided on a comparable basis without charge to all tenants in the building;

(ix) If a low-income unit in the project became vacant during the year, that reasonable attempts were or are being made to rent that unit or the next available unit of comparable or smaller size to tenants having a qualifying income before any units in the project were or will be rented to tenants not having a qualifying income;

(x) If the income of tenants of a low-income unit in the building increased above the limit allowed in section 42(g)(2)(D)(ii), the next available unit of comparable or smaller size in the building was or will be rented to tenants having a qualifying income;

(xi) An extended low-income housing commitment as described in section 42(h)(6) was in effect (for buildings subject to section 7108(c)(1) of the Omnibus Budget Reconciliation Act of 1989, 103 Stat. 2106, 2308–2311), including the requirement under section 42(h)(6)(B)(iv) that an owner cannot refuse to lease a unit in the project to an applicant because the applicant holds a voucher or certificate of eligibility under section 8 of the United States Housing Act of 1937, 42 U.S.C. 1437f (for buildings subject to section 13142(b)(4) of the Omnibus Budget Reconciliation Act of 1993, 107 Stat. 312, 438–439); and

(xii) All low-income units in the project were used on a nontransient basis (except for transitional housing for the homeless provided under section 42(i)(3)(B)(iii) or single-room-occupancy units rented on a month-by-month basis under section 42(i)(3)(B)(iv)).

(2) *Review.* The review provision must—

(i) Require that the Agency review the certifications submitted under paragraph (c)(1) of this section for compliance with the requirements of section 42;

(ii) [Reserved]. For further guidance, see §1.42–5T(c)(2)(ii).

(iii) [Reserved]. For further guidance, see §1.42–5T(c)(2)(iii).

(3) [Reserved]. For further guidance, see §1.42–5T(c)(3).

(4) *Exception for certain buildings*—(i) *In general.* The review requirements under paragraph (c)(2)(ii) of this section may provide that owners are not required to submit, and the Agency is not required to review, the tenant income certifications, supporting documentation, and rent records for buildings financed by the Rural Housing Service (RHS), formerly known as Farmers Home Administration, under the section 515 program, or buildings of which 50 percent or more of the aggregate basis (taking into account the building and the land) is financed with the proceeds of obligations the interest on which is exempt from tax under section 103 (tax-exempt bonds). In order for a monitoring procedure to except these buildings, the Agency must meet the requirements of paragraph (c)(4)(ii) of this section.

(ii) *Agreement and review.* The Agency must enter into an agreement with the RHS or tax-exempt bond issuer. Under the agreement, the RHS or tax-exempt bond issuer must agree to provide information concerning the income and rent of the tenants in the building to the Agency. The Agency may assume the accuracy of the information provided by RHS or the tax-exempt bond issuer without verification. The Agency must review the information and determine that the income limitation and rent restriction of section 42 (g)(1) and (2) are met. However, if the information provided by the RHS or tax-exempt bond issuer is not sufficient for the Agency to make this determination, the Agency must request the necessary additional income or rent information from the owner of the buildings. For example, because RHS determines tenant eligibility based on its definition of ''adjusted annual income,'' rather than ''annual income'' as defined under Section 8, the Agency may have to calculate the tenant's income for section 42 purposes and may need to request additional income information from the owner.

(iii) *Example.* The exception permitted under paragraph (c)(4)(i) and (ii) of this section is illustrated by the following example.

Example. An Agency selects for review buildings financed by the RHS. The Agency has entered into an agreement described in paragraph (c)(4)(ii) of this section with the RHS with respect to those buildings. In reviewing the RHS-financed buildings, the Agency obtains the tenant income and rent information from the RHS for 20 percent of the low-income units in each of those buildings. The Agency calculates the tenant income and rent to determine whether the tenants meet the income and rent limitation of section 42 (g)(1) and (2). In order to make this determination, the Agency may need to request additional income or rent information from the owners of the RHS buildings if the information provided by the RHS is not sufficient.

(5) *Agency reports of compliance monitoring activities.* The Agency must report its compliance monitoring activities annually on Form 8610, ''Annual Low-Income Housing Credit Agencies Report.''

(d) *Inspection provision*—(1) *In general.* Under the inspection provision, the Agency must have the right to perform an on-site inspection of any low-income housing project at least through the end of the compliance period of the buildings in the project. The inspection provision of this paragraph (d) is a separate requirement from any tenant file review under paragraph (c)(2)(ii) of this section.

(2) *Inspection standard.* For the on-site inspections of buildings and low-income units required by paragraph (c)(2)(ii) of this section, the Agency must review any local health, safety, or building code violations reports or notices retained by the owner under paragraph (b)(3) of this section and must determine—

(i) Whether the buildings and units are suitable for occupancy, taking into account local health, safety, and building codes (or other habitability standards); or

(ii) Whether the buildings and units satisfy, as determined by the Agency, the uniform physical condition standards for public housing established by HUD (24 CFR 5.703). The HUD physical condition standards do not supersede or preempt local health, safety, and building codes. A low-income housing project under section 42 must continue to satisfy these codes and, if the Agency becomes aware of any violation of these codes, the Agency must report the violation to the Service. However, provided the Agency determines by inspection that the HUD standards are met, the Agency is not required under this paragraph (d)(2)(ii) to determine by inspection whether the project meets local health, safety, and building codes.

(3) *Exception from inspection provision.* An Agency is not required to inspect a building under this paragraph (d) if the building is financed by the RHS under the section 515 program, the RHS inspects the building (under 7 CFR part 1930), and the RHS and Agency enter into a memorandum of understanding, or other similar arrangement, under which the RHS agrees to notify the Agency of the inspection results.

(4) *Delegation.* An Agency may delegate inspection under this paragraph (d) to an Authorized Delegate retained under paragraph (f) of this section. Such Authorized Delegate, which may include HUD or a HUD-approved inspector, must notify the Agency of the inspection results.

(e) *Notification-of-noncompliance provision*—(1) *In general.* Under the notification-of-noncompliance provisions, the Agency must be required to give the notice described in paragraph (e)(2) of this section to the owner of a low-income housing project and the notice described in paragraph (e)(3) of this section to the Service.

(2) *Notice to owner.* The Agency must be required to provide prompt written notice to the owner of a low-income housing project if the Agency does not receive the certification described in paragraph (c)(1) of this section, or does not receive or is not permitted to inspect the tenant income certifications, supporting documentation, and rent records described in paragraph (c)(2)(ii) of this section, or discovers by inspection, review, or in some other manner, that the project is not in compliance with the provisions of section 42.

(3) *Notice to Internal Revenue Service*—(i) *In general.* The Agency must be required to file Form 8823, ''Low-Income Housing Credit Agencies Report of Noncompliance,'' with the Service no later than 45 days after the end of the correction period (as described in paragraph (e)(4) of this section, including extensions permitted under that paragraph) and no earlier than the end of the correction period, whether or not the noncompliance or failure to certify is corrected. The Agency must explain on Form 8823 the nature of the noncompliance or failure to certify and indicate whether the owner has corrected the noncompliance or failure to certify. Any change in either the applicable fraction or eligible basis under paragraph (c)(1)(ii) and (vii) of this section, respectively, that results in a decrease in the qualified basis of the project under section 42 (c)(1)(A) is noncompliance that must be reported to the Service under this paragraph (e)(3). If an Agency reports on Form 8823 that a building is entirely out of compliance and will not be in compliance at any time in the future, the Agency need not file Form 8823 in subsequent years to report that building's noncompliance. If the noncompliance or failure to certify is corrected within 3 years after the end of the correction period, the Agency is required to file Form 8823 with the Service reporting the correction of the noncompliance or failure to certify.

(ii) *Agency retention of records.* An Agency must retain records of noncompliance or failure to certify for 6 years beyond the Agency's filing of the respective Form 8823. In all other cases, the Agency must retain the certifications and records described in paragraph (c) of this section for 3 years from the end of the calendar year the Agency receives the certifications and records.

(4) *Correction period.* The correction period shall be that period specified in

the monitoring procedure during which an owner must supply any missing certifications and bring the project into compliance with the provisions of section 42. The correction period is not to exceed 90 days from the date of the notice to the owner described in paragraph (e)(2) of this section. An Agency may extend the correction period for up to 6 months, but only if the Agency determines there is good cause for granting the extension.

(f) *Delegation of Authority*—(1) *Agencies permitted to delegate compliance monitoring functions*—(i) *In general.* An Agency may retain an agent or other private contractor (''Authorized Delegate'') to perform compliance monitoring. The Authorized Delegate must be unrelated to the owner of any building that the Authorized Delegate monitors. The Authorized Delegate may be delegated all of the functions of the Agency, except for the responsibility of notifying the Service under paragraphs (c)(5) and (e)(3) of this section. For example, the Authorized Delegate may be delegated the responsibility of reviewing tenant certifications and documentation under paragraph (c) (1) and (2) of this section, the right to inspect buildings and records as described in paragraph (d) of this section, and the responsibility of notifying building owners of lack of certification or noncompliance under paragraph (e)(2) of this section. The Authorized Delegate must notify the Agency of any noncompliance or failure to certify.

(ii) *Limitations.* An Agency that delegates compliance monitoring to an Authorized Delegate under paragraph (f)(1)(i) of this section must use reasonable diligence to ensure that the Authorized Delegate properly performs the delegated monitoring functions. Delegation by an Agency of compliance monitoring functions to an Authorized Delegate does not relieve the Agency of its obligation to notify the Service of any noncompliance of which the Agency becomes aware.

(2) *Agencies permitted to delegate compliance monitoring functions to another Agency.* An Agency may delegate all or some of its compliance monitoring responsibilities for a building to another Agency within the State. This delegation may include the responsibility of notifying the Service under paragraph (e)(3) of this section.

(g) *Liability.* Compliance with the requirements of section 42 is the responsibility of the owner of the building for which the credit is allowable. The Agency's obligation to monitor for compliance with the requirements of section 42 does not make the Agency liable for an owner's noncompliance.

(h) *Effective/applicability dates*—(1) *In general.* Allocation plans must comply with these regulations by June 30, 1993. The requirement of section 42 (m)(1)(B)(iii) that allocation plans contain a procedure for monitoring for noncompliance becomes effective on January 1, 1992, and applies to buildings for which a low-income housing credit is, or has been, allowable at any time. Thus, allocation plans must comply with section 42(m)(1)(B)(iii) prior to June 30, 1993, the effective date of these regulations. An allocation plan that complies with these regulations, with the notice of proposed rulemaking published in the FEDERAL REGISTER on December 27, 1991, or with a reasonable interpretation of section 42(m)(1)(B)(iii) will satisfy the requirements of section 42(m)(1)(B)(iii) for periods before June 30, 1993. Section 42(m)(1)(B)(iii) and these regulations do not require monitoring for whether a building or project is in compliance with the requirements of section 42 prior to January 1, 1992. However, if an Agency becomes aware of noncompliance that occurred prior to January 1, 1992, the Agency is required to notify the Service of that noncompliance. In addition, the requirements in paragraphs (b)(3) and (c)(1)(v), (vi), and (xi) of this section (involving recordkeeping and annual owner certifications) and paragraphs (c)(2)(ii)(B), (c)(2)(iii), and (d) of this section (involving tenant file reviews and physical inspections of existing projects, and the physical inspection standard) are applicable January 1, 2001. The requirement in paragraph (c)(2)(ii)(A) of this section (involving tenant file reviews and physical inspections of new projects) is applicable for buildings placed in service on or after January 1, 2001. The requirements in paragraph (c)(5) of this section (involving Agency reporting of compliance monitoring activities to the Service) and paragraph (e)(3)(i) of this section (involving Agency reporting of corrected noncompliance or failure to certify within 3 years after the end of the correction period) are applicable January 14, 2000.

(2) [Reserved]. For further guidance, see §1.42–5T(h)(2).

(i) [Reserved]. For further guidance, see §1.42–5T(i).

[T.D. 8430, 57 FR 40121, Sept. 2, 1992; 57 FR 57280, Dec. 3, 1992; 58 FR 7748, Feb. 9, 1993; T.D. 8563, 59 FR 50163, Oct. 3, 1994; T.D. 8859, 65 FR 2326, Jan. 14, 2000; 65 FR 16317, Mar. 28, 2000; T.D. 9753, 81 FR 9336, Feb. 25, 2016]

§ 1.42–5T Monitoring compliance with low-income housing credit requirements (temporary).

(a)(1) through (a)(2)(ii) [Reserved]. For further guidance, see §1.42–5(a)(1) through (a)(2)(ii).

(iii) *Effect of guidance published in the Internal Revenue Bulletin.* Guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter) may provide—

(A) Exceptions to the requirements referred to in §1.42–5(a)(2)(i) and the requirements described in this section; or

(B) Alternative means of satisfying those requirements.

(b) through (c)(2)(i) [Reserved]. For further guidance, see §1.42–5(b) through (c)(2)(i).

(ii) Require that, with respect to each low-income housing project, the Agency conduct on-site inspections and review low-income certifications (including in that term the documentation supporting the low-income certifications and the rent records for tenants).

(iii) Require that the on-site inspections that the Agency must conduct satisfy both the requirements of §1.42–5(d) and the requirements in paragraph (c)(2)(iii)(A) through (D) of this section, and require that the low-income certification review that the Agency must perform satisfies the requirements in paragraphs (c)(2)(iii)(A) through (D) of this section. Paragraph (c)(2)(iii)(A) through (D) of this section provides rules determining how these on-site inspection requirements and how these low-income certification review requirements may be satisfied by an inspection or review, as the case may be, that includes only a sample of the low-income units.

(A) *Timing.* The Agency must conduct on-site inspections of all buildings in the low-income housing project and must review low-income certifications of the low-income housing project—

(*1*) By the end of the second calendar year following the year the last building in the low-income housing project is placed in service; and

(*2*) At least once every 3 years thereafter.

(B) *Number of low-income units.* The Agency must conduct on-site inspections and low-income certification review of not fewer than the minimum number of low-income units required by guidance published in the Internal Revenue Bulletin. See §601.601(d)(2)(ii)(*b*) of this chapter.

(C) *Selection of low-income units for inspection and low-income certifications for review—*(*1*) *Random selection.* The Agency must select in a random manner the low-income units to be inspected and the units whose low-income certifications are to be reviewed. The Agency is not required to select the same low-income units of a low-income housing project for on-site inspections and low-income certification review, and an Agency may choose a different number of units for on-site inspections and for low-income certification review, provided the Agency chooses at least the minimum number of low-income units in each case. If the Agency chooses to select different low-income units for on-site inspections and low-income certification review, the Agency must select the units for on-site inspections or low-income certification review separately and in a random manner.

(*2*) *Advance notification limited to reasonable notice.* The Agency must select the low-income units to inspect and low-income certifications to review in a manner that will not give advance notice that a particular low-income unit (or low-income certifications for a particular low-income unit) for a particular year will or will not be inspected (or reviewed). However, the Agency may give an owner reasonable notice that an inspection of the building and low-income units or review of low-income certifications will occur.

The notice is to enable the owner to notify tenants of the inspection or to assemble low-income certifications for review.

(*3*) *Meaning of reasonable notice.* For purposes of paragraph (c)(2)(iii)(C)(*ii*) of this section, reasonable notice is generally no more than 30 days. The notice period begins on the date the Agency informs the owner of the identity of the units for which on-site inspections or low-income certification review will or will not occur. Notice of more than 30 days, however, may be reasonable in extraordinary circumstances that are beyond an Agency's control and that prevent an Agency from carrying out within 30 days an on-site inspection or low-income certification review. Extraordinary circumstances include, but are not limited to, natural disasters and severe weather conditions. In the event of extraordinary circumstances that result in a reasonable-notice period longer than 30 days, an Agency must conduct the on-site inspection or low-income certification review as soon as practicable.

(*4*) *Applicability of reasonable notice limitation when the same units are chosen for inspection and file review.* If the Agency chooses to select the same units for on-site inspections and low-income certification review, the Agency may conduct on-site inspections and low-income certification review either at the same time or separately. The Agency, however, must conduct both the inspections and review within the reasonable-notice period described in paragraph (c)(2)(iii)(C)(*2*) and (*3*) of this section.

(D) *Method of low-income certification review.* The Agency may review the low-income certifications wherever the owner maintains or stores the records (either on-site or off-site).

(3) *Frequency and form of certification.* A monitoring procedure must require that the certifications and reviews of §1.42–5(c)(1) and (c)(2)(i) be made at least annually covering each year of the 15-year compliance period under section 42(i)(1). The certifications must be made under penalty of perjury. A monitoring procedure may require certifications and reviews more frequently than every 12 months, provided that all months within each 12-month period are subject to certification.

(c)(4) through (h)(1) [Reserved]. For further guidance, see §1.42–5(c)(4) through (h)(1).

(2) *Effective/applicability dates of the REAC inspection protocol.* The requirements in paragraphs (a)(2)(iii), (c)(2)(ii) and (iii), and (c)(3) of this section apply beginning on February 25, 2016. Agencies using the REAC inspection protocol of the Department of Housing and Urban Development as part of the Physical Inspections Pilot Program may rely on these provisions for on-site inspections and low-income certification review occurring between January 1, 2015 and February 25, 2016. Otherwise, for the rules that apply before February 25, 2016, see §1.42–5 as contained in 26 CFR part 1 revised as of April 1, 2015.

(i) *Expiration date.* The applicability of this section expires on February 22, 2019.

[T.D. 9753, 81 FR 9337, Feb. 25, 2016]

§1.42–6 Buildings qualifying for carryover allocations.

(a) *Carryover allocations*—(1) *In general.* A carryover allocation is an allocation that meets the requirements of section 42(h)(1)(E) or (F). If the requirements of section §42(h)(1)(E) or (F) that are required to be satisfied by the close of a calendar year are not satisfied, the allocation is not valid and is treated as if it had not been made for that calendar year. For example, if a carryover allocation fails to satisfy a requirement in §1.42–6(d) for making an allocation, such as failing to be signed or dated by an authorized official of an allocating agency by the close of a calendar year, the allocation is not valid and is treated as if it had not been made for that calendar year.

(2) *10 percent basis requirement.* A carryover allocation may only be made with respect to a qualified building. A qualified building is any building which is part of a project if, by the date specified under paragraph (a)(2)(i) or (ii) of this section, a taxpayer's basis in the project is more than 10 percent of the taxpayer's reasonably expected basis in the project as of the close of the second calendar year following the calendar year the allocation is made.

For purposes of meeting the 10 percent basis requirement, the determination of whether a building is part of a single-building project or multi-building project is based on whether the carryover allocation is made under section 42(h)(1)(E) (building-based allocation) or section 42(h)(1)(F) (project-based allocation). In the case of a multi-building project that receives an allocation under section 42(h)(1)(F), the 10 percent basis requirement is satisfied by reference to the entire project.

(i) *Allocation made before July 1.* If a carryover allocation is made before July 1 of a calendar year, a taxpayer must meet the 10 percent basis requirement by the close of that calendar year. If a taxpayer does not meet the 10 percent basis requirement by the close of the calendar year, the carryover allocation is not valid and is treated as if it had not been made.

(ii) *Allocation made after June 30.* If a carryover allocation is made after June 30 of a calendar year, a taxpayer must meet the 10 percent basis requirement by the close of the date that is 6 months after the date the allocation was made. If a taxpayer does not meet the 10 percent basis requirement by the close of the required date, the carryover allocation must be returned to the Agency. Unlike a carryover allocation made before July 1, if a taxpayer does not meet the 10 percent basis requirement by the close of the required date, the carryover allocation is treated as a valid allocation for the calendar year of allocation, but is included in the ''returned credit component'' for purposes of determining the State housing credit ceiling under section 42(h)(3)(C) for the calendar year following the calendar year of the allocation. See §1.42–14(d)(1).

(b) *Carryover-allocation basis*—(1) *In general.* Subject to the limitations of paragraph (b)(2) of this section, a taxpayer's basis in a project for purposes of section 42(h)(1) (E)(ii) or (F) (carryover-allocation basis) is the taxpayer's adjusted basis in land or depreciable property that is reasonably expected to be part of the project, whether or not these amounts are includible in eligible basis under section 42(d). Thus, for example, if the project is to include property that is not residential rental property, such as commercial space, the basis attributable to the commercial space, although not includible in eligible basis, is includible in carryover-allocation basis. The adjusted basis of land and depreciable property is determined under sections 1012 and 1016, and generally includes the direct and indirect costs of acquiring, constructing, and rehabilitating the property. Costs otherwise includible in carryover-allocation basis are not excluded by reason of having been incurred prior to the calendar year in which the carryover allocation is made.

(2) *Limitations*—For purposes of determining carryover-allocation basis under paragraph (b)(1) of this section, the following limitations apply.

(i) *Taxpayer must have basis in land or depreciable property related to the project.* A taxpayer has carryover-allocation basis to the extent that it has basis in land or depreciable property and the land or depreciable property is reasonably expected to be part of the project for which the carryover allocation is made. This basis includes all items that are properly capitalizable with respect to the land or depreciable property. For example, a nonrefundable downpayment for, or an amount paid to acquire an option to purchase, land or depreciable property may be included in carryover-allocation basis if properly capitalizable into the basis of land or depreciable property that is reasonably expected to be part of a project.

(ii) *High cost areas.* Any increase in eligible basis that may result under section 42(d)(5)(C) from a building's location in a qualified census tract or difficult development area is not taken into account in determining carryover-allocation basis or reasonably expected basis.

(iii) *Amounts not treated as paid or incurred.* An amount is not includible in carryover-allocation basis unless it is treated as paid or incurred under the method of accounting used by the taxpayer. For example, a cash method taxpayer cannot include construction costs in carryover-allocation basis unless the costs have been paid, and an accrual method taxpayer cannot include construction costs in carryover-allocation basis unless they have been properly accrued. See paragraph (b)(2)(iv) of this section for a special rule for fees.

(iv) *Fees.* A fee is includible in carryover-allocation basis only to the extent the requirements of paragraph (b)(2)(iii) of this section are met and—

(A) The fee is reasonable;

(B) The taxpayer is legally obligated to pay the fee;

(C) The fee is capitalizable as part of the taxpayer's basis in land or depreciable property that is reasonably expected to be part of the project;

(D) The fee is not paid (or to be paid) by the taxpayer to itself; and

(E) If the fee is paid (or to be paid) by the taxpayer to a related person, and the taxpayer uses the cash method of accounting, the taxpayer could properly accrue the fee under the accrual method of accounting (considering, for example, the rules of section 461(h)). A person is a related person if the person bears a relationship to the taxpayer specified in sections 267(b) or 707(b)(1), or if the person and the taxpayer are engaged in trades or businesses under common control (within the meaning of subsections (a) and (b) of section 52).

(3) *Reasonably expected basis.* Rules similar to the rules of paragraphs (a) and (b) of this section apply in determining the taxpayer's reasonably expected basis in a project (land and depreciable basis) as of the close of the second calendar year following the calendar year of the allocation.

(4) *Examples.* The following examples illustrate the rules of paragraphs (a) and (b) of this section.

Example 1. (i) *Facts.* C, an accrual-method taxpayer, receives a carryover allocation from Agency, the state housing credit agency, in May of 2003. As of that date, C has not begun construction of the low-income housing building C plans to build. However, C has owned the land on which C plans to build the building since 1985. C's basis in the land is $100,000. C reasonably expects that by the end of 2005, C's basis in the project of which the building is to be a part will be $2,000,000. C also expects that because the project is located in a qualified census tract, C will be able to increase its basis in the project to $2,600,000. Before the close of 2003, C incurs $150,000 of costs for architects' fees and site preparation. C properly accrues these costs under its method of accounting and capitalizes the costs.

(ii) *Determination of carryover-allocation basis.* C's $100,000 basis in the land is includible in carryover-allocation basis even though C has owned the land since 1985. The $150,000 of costs C has incurred for architects' fees and site preparation are also includible in carryover-allocation basis. The expected increase in basis due to the project's location in a qualified census tract is not taken into account in determining C's carryover-allocation basis. Accordingly, C's carryover-allocation basis in the project of which the building is a part is $250,000.

(iii) *Determination of whether building is qualified.* C's reasonably expected basis in the project at the close of the second calendar year following the calendar year of allocation is $2,000,000. The expected increase in eligible basis due to the project's location in a qualified census tract is not taken into account in determining this amount. Because C's carryover-allocation basis is more than 10 percent of C's reasonably expected basis in the project of which the building is a part, the building for which C received the carryover allocation is a qualified building for purposes of section 42(h)(1)(E)(ii) and paragraph (a) of this section.

Example 2. (i) *Facts.* D, an accrual-method taxpayer, received a carryover allocation from Agency, the state housing credit agency of State X, on September 12, 2003. As of that date, D has not begun construction of the low-income housing building D plans to build and D does not have basis in the land on which D plans to build the building. From September 12, 2003, to the close of March 12, 2004, D incurs some costs related to the planned building, including architects' fees. As of the close of March 12, 2004, these costs do not exceed 10 percent of D's reasonably expected basis in the single-building project as of the close of 2005.

(ii) *Determination of whether building is qualified.* Because D's carryover-allocation basis as of the close of March 12, 2004, is not more than 10 percent of D's reasonably expected basis in the single-building project, the building is not a qualified building for purposes of section 42(h)(1)(E)(ii) and paragraph (a) of this section. Accordingly, the carryover allocation to D must be returned to the Agency. The allocation is valid for purposes of determining the amount of credit allocated by Agency from State X's 2003 State housing credit ceiling, but is included in the returned credit component of State X's 2004 housing credit ceiling.

(c) *Verification of basis by Agency*—(1) *Verification requirement.* An Agency that makes a carryover allocation to a taxpayer must verify that the taxpayer has met the 10 percent basis requirement of paragraph (a)(2) of this section.

(2) *Manner of verification.* An Agency may verify that a taxpayer has incurred more than 10 percent of its reasonably expected basis in a project by obtaining a certification from the taxpayer, in writing and under penalty of perjury, that the taxpayer has incurred by the close of the calendar year of the allocation (for allocations made before July 1) or by the close of the date that is 6 months after the date the allocation is made (for allocations made after June 30) more than 10 percent of the reasonably expected basis in the project. The certification must be accompanied by supporting documentation that the Agency must review. Supporting documentation may include, for example, copies of checks or other records of payments. Alternatively, an Agency may verify that the taxpayer has incurred adequate basis by requiring that the taxpayer obtain from an attorney or certified public accountant a written certification to the Agency, that the attorney or accountant has examined all eligible costs incurred with respect to the project and that, based upon this examination, it is the attorney's or accountant's belief that the taxpayer has incurred more than 10 percent of its reasonably expected basis in the project by the close of the calendar year of the allocation (for allocations made before July 1) or by the close of the date that is 6 months after the date the allocation is made (for allocations made after June 30).

(3) *Time of verification*—(i) *Allocations made before July 1.* For a carryover allocation made before July 1, an Agency may require that the basis certification be submitted to or received by the Agency prior to the close of the calendar year of allocation or within a reasonable time following the close of the calendar year of allocation. The Agency will need to verify basis as provided in paragraph (c)(2) of this section to accurately complete the Form 8610, ''Annual Low-Income Housing Credit Agencies Report,'' and the Schedule A (Form 8610), ''Carryover Allocation of Low-Income Housing Credit,'' for the calendar year of the allocation. If the basis certification is not timely made, or supporting documentation is lacking, inadequate, or does not actually support the certification, the Agency should notify the taxpayer and try to get adequate documentation. If the Agency cannot verify before the Form 8610 is filed that the taxpayer has satisfied the 10 percent basis requirement for a carryover allocation made before July 1, the allocation is not valid and is treated as if it had not been made and the carryover allocation should not be reported on the Schedule A (Form 8610).

(ii) *Allocations made after June 30.* An Agency may require that the basis certification be submitted to or received by the Agency prior to the close of the date that is 6 months after the date the allocation was made or within a reasonable period of time following the close of the date that is 6 months after the date the allocation was made. The Agency will need to verify basis as provided in paragraph (c)(2) of this section. If the basis certification is not timely made, or supporting documentation is lacking, inadequate, or does not actually support the certification, the Agency should notify the taxpayer and try to get adequate documentation. If the Agency cannot verify that the taxpayer has satisfied the 10 percent basis requirement for a carryover allocation made after June 30, the allocation must be returned to the Agency. The carryover allocation is a valid allocation for the calendar year of the allocation, but is included in the returned credit component of the State housing credit ceiling for the calendar year following the calendar year of the allocation.

(d) *Requirements for making carryover allocations*—(1) *In general.* Generally, an allocation is made when an Agency issues the Form 8609, 'Low-Income Housing Credit Allocation Certification,' for a building. See §1.42–1T(d)(8)(ii). An Agency does not issue the Form 8609 for a building until the building is placed in service. However, in cases where allocations of credit are made pursuant to section 42(h)(1)(E) (relating to carryover allocations for buildings) or section 42(h)(1)(F) (relating to carryover allocations for multiple-building projects), Form 8609 is not used as the allocating document because the buildings are not yet in service. When an allocation is made pursuant to section 42(h)(1) (E) or (F), the allocating document is the document meeting the requirements of paragraph (d)(2) of this section. In addition, when an allocation is made pursuant to section 42(h)(1)(F), the requirements of paragraph (d)(3) of this section must be met for the allocation to be valid. An allocation pursuant to section 42(h)(1) (E) or (F) reduces the state housing credit ceiling for the year in which the allocation is made, whether or not the Form 8609 is also issued in that year.

(2) *Requirements for allocation*. An allocation pursuant to section 42(h)(1) (E) or (F) is made when an allocation document containing the following information is completed, signed, and dated by an authorized official of the Agency—

(i) The address of each building in the project, or if none exists, a specific description of the location of each building;

(ii) The name, address, and taxpayer identification number of the taxpayer receiving the allocation;

(iii) The name and address of the Agency;

(iv) The taxpayer identification number of the Agency;

(v) The date of the allocation;

(vi) The housing credit dollar amount allocated to the building or project, as applicable;

(vii) The taxpayer's reasonably expected basis in the project (land and depreciable basis) as of the close of the second calendar year following the calendar year in which the allocation is made;

(viii) For carryover allocations made before July 1, the taxpayer's basis in the project (land and depreciable basis) as of the close of the calendar year of the allocation and the percentage that basis bears to the reasonably expected basis in the project (land and depreciable basis) as of the close of the second calendar year following the calendar year of allocation;

(ix) The date that each building in the project is expected to be placed in service; and

(x) The Building Identification Number (B.I.N.) to be assigned to each building in the project. The B.I.N. must reflect the year an allocation is first made to the building, regardless of the year that the building is placed in service. This B.I.N. must be used for all allocations of credit for the building. For example, rehabilitation expenditures treated as a separate new building under section 42(e) should not have a separate B.I.N. if the building to which the rehabilitation expenditures are made has a B.I.N. In this case, the B.I.N. used for the rehabilitation expenditures shall be the B.I.N. previously assigned to the building, although the rehabilitation expenditures must have a separate Form 8609 for the allocation. Similarly, a newly constructed building that receives an allocation of credit in different calendar years must have a separate Form 8609 for each allocation. The B.I.N. assigned to the building for the first allocation must be used for the subsequent allocation.

(3) *Special rules for project-based allocations*—(i) *In general*. An allocation pursuant to section 42(h)(1)(F) (a project-based allocation) must meet the requirements of this section as well as the requirements of section 42(h)(1)(F), including the minimum basis requirement of section 42(h)(1)(E)(ii).

(ii) *Requirement of section 42(h)(1)(F)(i)(III)*. An allocation satisfies the requirement of section 42(h)(1)(F)(i)(III) if the Form 8609 that is issued for each building that is placed in service in the project states the portion of the project-based allocation that is applied to that building.

(4) *Recordkeeping requirements*—(i) *Taxpayer*. When an allocation is made pursuant to section 42(h)(1)(E) or (F), the taxpayer must retain a copy of the allocation document. The Form 8609 that reflects the allocation must be filed for the first taxable year that the credit is claimed and for each taxable year thereafter throughout the compliance period, whether or not a credit is claimed for the taxable year.

(ii) *Agency*. The Agency must retain the original carryover allocation document made under paragraph (d)(2) of this section and file Schedule A (Form 8610) with the Agency's Form 8610 for the year the allocation is made. The Agency must also retain a copy of the Form 8609 that is issued to the taxpayer and file the original with the

Agency's Form 8610 that reflects the year the form is issued.

(5) *Separate procedure for election of appropriate percentage month.* If a taxpayer receives an allocation under section 42(h)(1) (E) or (F) and wishes to elect under section 42(b)(2)(A)(ii) to use the appropriate percentage for a month other than the month in which a building is placed in service, the requirements specified in §1.42–8 must be met for the election to be effective.

(e) *Special rules.* The following rules apply for purposes of this section.

(1) *Treatment of partnerships and other flow-through entities.* With respect to taxpayers that own projects through partnerships or other flow-through entities (e.g., S corporations, estates, or trusts), carryover-allocation basis is determined at the entity level using the rules provided by this section. In addition, the entity is responsible for providing to the Agency the certification and documentation required under the basis verification requirement in paragraph (c) of this section.

(2) *Transferees.* If land or depreciable property that is expected to be part of a project is transferred after a carryover allocation has been made for a building that is reasonably expected to be part of the project, but before the close of the calendar year of the allocation (for allocations made before July 1) or by the close of the date that is 6 months after the date the allocation is made (for allocations made after June 30), the transferee's carryover-allocation basis is determined under the principles of this section and section 42(d)(7). See also Rev. Rul. 91–38, 1991–2 C.B. 3 (see §601.601(d)(2)(ii)(*b*) of this chapter). In addition, the transferee is treated as the taxpayer for purposes of the basis verification requirement of this section, and therefore, is responsible for providing to the Agency the required certifications and documentation.

[T.D. 8520, 59 FR 10069, Mar. 3, 1994, as amended by T.D. 8859, 65 FR 2328, Jan. 14, 2000; 65 FR 16317, Mar. 28, 2000; T.D. 9110, 69 FR 502, Jan. 6, 2004]

§ 1.42–7 Substantially bond-financed buildings. [Reserved]

§ 1.42–8 Election of appropriate percentage month.

(a) *Election under section 42(b)(2)(A)(ii)(I) to use the appropriate percentage for the month of a binding agreement*—(1) *In general.* For purposes of section 42(b)(2)(A)(ii)(I), an agreement between a taxpayer and an Agency as to the housing credit dollar amount to be allocated to a building is considered binding if it—

(i) Is in writing;

(ii) Is binding under state law on the Agency, the taxpayer, and all successors in interest;

(iii) Specifies the type(s) of building(s) to which the housing credit dollar amount applies (*i.e.*, a newly constructed or existing building, or substantial rehabilitation treated as a separate new building under section 42(e));

(iv) Specifies the housing credit dollar amount to be allocated to the building(s); and

(v) Is dated and signed by the taxpayer and the Agency during the month in which the requirements of paragraphs (a)(1) (i) through (iv) of this section are met.

(2) *Effect on state housing credit ceiling.* Generally, a binding agreement described in paragraph (a)(1) of this section is an agreement by the Agency to allocate credit to the taxpayer at a future date. The binding agreement may include a reservation of credit or a binding commitment (under section 42(h)(1)(C)) to allocate credit in a future taxable year. A reservation or a binding commitment to allocate credit in a future year has no effect on the state housing credit ceiling until the year the Agency actually makes an allocation. However, if the binding agreement is also a carryover allocation under section 42(h)(1) (E) or (F), the state housing credit ceiling is reduced by the amount allocated by the Agency to the taxpayer in the year the carryover allocation is made. For a binding agreement to be a valid carryover allocation, the requirements of paragraph (a)(1) of this section and §1.42–6 must be met.

(3) *Time and manner of making election.* An election under section

42(b)(2)(A)(ii)(I) may be made either as part of the binding agreement under paragraph (a)(1) of this section to allocate a specific housing credit dollar amount or in a separate document that references the binding agreement. In either case, the election must—

(i) Be in writing;

(ii) Reference section 42(b)(2)(A)(ii)(I);

(iii) Be signed by the taxpayer;

(iv) If it is in a separate document, reference the binding agreement that meets the requirements of paragraph (a)(1) of this section; and

(v) Be notarized by the 5th day following the end of the month in which the binding agreement was made.

(4) *Multiple agreements*—(i) *Rescinded agreements*. A taxpayer may not make an election under section 42(b)(2)(A)(ii)(I) for a building if an election has previously been made for the building for a different month. For example, assume a taxpayer entered into a binding agreement for allocation of a specific housing credit dollar amount to a building and made the election under section 42(b)(2)(A)(ii)(I) to apply the appropriate percentage for the month of the binding agreement. If the binding agreement subsequently is rescinded under state law, and the taxpayer enters into a new binding agreement for allocation of a specific housing credit dollar amount to the building, the taxpayer must apply to the building the appropriate percentage for the elected month of the rescinded binding agreement. However, if no prior election was made with respect to the rescinded binding agreement, the taxpayer may elect the appropriate percentage for the month of the new binding agreement.

(ii) *Increases in credit*. The election under section 42(b)(2)(A)(ii)(I), once made, applies to any increase in the credit amount allocated for a building, whether the increase occurs in the same or in a subsequent year. However, in the case of a binding agreement (or carryover allocation that is treated as a binding agreement) to allocate a credit amount under section 42(e)(1) for substantial rehabilitation treated as a separate new building, a taxpayer may make the election under section 42(b)(2)(A)(ii)(I) notwithstanding that a prior election under section 42(b)(2)(A)(ii)(I) is in effect for a prior allocation of credit for a substantial rehabilitation that was previously placed in service under section 42(e).

(5) *Amount allocated*. The housing credit dollar amount eventually allocated to a building may be more or less than the amount specified in the binding agreement. Depending on the Agency's determination pursuant to section 42(m)(2) as to the financial feasibility of the building (or project), the Agency may allocate a greater housing credit dollar amount to the building (provided that the Agency has additional housing credit dollar amounts available to allocate for the calendar year of the allocation) or the Agency may allocate a lesser housing credit dollar amount. Under section 42(h)(7)(D), in allocating a housing credit dollar amount, the Agency must specify the applicable percentage and maximum qualified basis of the building. The applicable percentage may be less, but not greater than, the appropriate percentage for the month the building is placed in service, or the month elected by the taxpayer under section 42(b)(2)(A)(ii)(I). Whether the appropriate percentage is the appropriate percentage for the 70-percent present value credit or the 30-percent present value credit is determined under section 42(i)(2) when the building is placed in service.

(6) *Procedures*—(i) *Taxpayer*. The taxpayer must give the original notarized election statement to the Agency before the close of the 5th calendar day following the end of the month in which the binding agreement is made. The taxpayer must retain a copy of the binding agreement and the election statement.

(ii) *Agency*. The Agency must retain the original of the binding agreement and election statement and, to the extent required by Schedule A (Form 8610), ''Carryover Allocation of Low-Income Housing Credit,'' account for the binding agreement and election statement on that schedule.

(7) *Examples*. The following examples illustrate the provisions of this section. In each example, X is the taxpayer, Agency is the state housing

credit agency, and the carryover allocations meet the requirements of § 1.42–6 and are otherwise valid.

Example 1. (i) In August 2003, X and Agency enter into an agreement that Agency will allocate $100,000 of housing credit dollar amount for the low-income housing building X is constructing. The agreement is binding and meets all the requirements of paragraph (a)(1) of this section. The agreement is a reservation of credit, not an allocation, and therefore, has no effect on the state housing credit ceiling. On or before September 5, 2003, X signs and has notarized a written election statement that meets the requirements of paragraph (a)(3) of this section. The applicable percentage for the building is the appropriate percentage for the month of August 2003.

(ii) Agency makes a carryover allocation of $100,000 of housing credit dollar amount for the building on October 2, 2003. The carryover allocation reduces Agency's state housing credit ceiling for 2003. Due to unexpectedly high construction costs, when X places the building in service in July 2004, the product of the building's qualified basis and the applicable percentage for the building (the appropriate percentage for the month of August 2003) is $150,000, rather than $100,000. Notwithstanding that only $100,000 of credit was allocated for the building in 2003, Agency may allocate an additional $50,000 of housing credit dollar amount for the building from its state housing credit ceiling for 2004. The appropriate percentage for the month of August 2003 is the applicable percentage for the building for the entire $150,000 of credit allocated for the building, even though separate allocations were made in 2003 and 2004. Because allocations were made for the building in two separate calendar years, Agency must issue two Forms 8609, ''Low-Income Housing Credit Allocation Certification,'' to X. One Form 8609 must reflect the $100,000 allocation made in 2003, and the other Form 8609 must reflect the $50,000 allocation made in 2004.

(iii) X gives the original notarized statement to Agency on or before September 5, 2003, and retains a copy of the binding agreement, election statement, and carryover allocation document.

(iv) Agency retains the original of the binding agreement, election statement, and 2003 carryover allocation document. Agency accounts for the binding agreement, election statement, and 2003 carryover allocation on the Schedule A (Form 8610) that it files for the 2003 calendar year. After the building is placed in service in 2004, and assuming other necessary requirements for issuing a Form 8609 are met (for example, taxpayer has certified all sources and uses of funds and development costs for the building under § 1.42–17), Agency issues to X a copy of the Form 8609 reflecting the 2003 carryover allocation of $100,000. Agency files the original of this Form 8609 with the Form 8610, ''Annual Low-Income Housing Credit Agencies Report,'' that it files for the 2004 calendar year. Agency also issues to X a copy of the Form 8609 reflecting the 2004 allocation of $50,000 and files the original of this Form 8609 with the Form 8610 that it files for the 2004 calendar year. Agency retains copies of the Forms 8609 that are issued to X.

Example 2. (i) In September 2003, X and Agency enter into an agreement that Agency will allocate $70,000 of housing credit dollar amount for rehabilitation expenditures that X is incurring and that X will treat as a new low-income housing building under section 42(e)(1). The agreement is binding and meets all the requirements of paragraph (a)(1) of this section. The agreement is a reservation of credit, not an allocation, and therefore, has no effect on Agency's state housing credit ceiling. On or before October 5, 2003, X signs and has notarized a written election statement that meets the requirements of paragraph (a)(3) of this section. The applicable percentage for the building is the appropriate percentage for the month of September 2003. Agency makes a carryover allocation of $70,000 of housing credit dollar amount for the building on November 15, 2003. The carryover allocation reduces by $70,000 Agency's state housing credit ceiling for 2003.

(ii) In October 2004, X and Agency enter into another binding agreement meeting the requirements of paragraph (a)(1) of this section. Under the agreement, Agency will allocate $50,000 of housing credit dollar amount for additional rehabilitation expenditures by X that qualify as a second separate new building under section 42(e)(1). On or before November 5, 2004, X signs and has notarized a written election statement meeting the requirements of paragraph (a)(3) of this section. On December 1, 2004, X receives a carryover allocation under section 42(h)(1)(E) for $50,000. The carryover allocation reduces by $50,000 Agency's state housing credit ceiling for 2004. The applicable percentage for the rehabilitation expenditures treated as the second separate new building is the appropriate percentage for the month of October 2004, not September 2003. The appropriate percentage for the month of September 2003 still applies to the allocation of $70,000 for the rehabilitation expenditures treated as the first separate new building. Because allocations were made for the building in two separate calendar years, Agency must issue two Forms 8609 to X. One Form 8609 must reflect the $70,000 allocation made in 2003, and the other Form 8609 must reflect the $50,000 allocation made in 2004.

(iii) X gives the first original notarized statement to Agency on or before October 5, 2003, and retains a copy of the first binding agreement, election statement, and carryover allocation document issued in 2003. X gives the second original notarized statement to Agency on or before November 5, 2004, and retains a copy of the second binding agreement, election statement, and carryover allocation document issued in 2004.

(iv) Agency retains the original of the binding agreements, election statements, and carryover allocation documents. Agency accounts for the binding agreement, election statement, and 2003 carryover allocation on the Schedule A (Form 8610) that it files for the 2003 calendar year. Agency also accounts for the binding agreement, election statement, and 2004 carryover allocation on the Schedule A (Form 8610) that it files for the 2004 calendar year. After each separate new building is placed in service, and assuming other necessary requirements for issuing a Form 8609 are met (for example, taxpayer has certified all sources and uses of funds and development costs for the building under §1.42–17), the Agency will issue to X a copy of the Form 8609 reflecting the 2003 carryover allocation of $70,000 and a copy of the Form 8609 reflecting the 2004 carryover allocation of $50,000, respectively. Agency files the original of each Form 8609 with the Form 8610 that reflects the calendar year each Form 8609 is issued. Agency retains copies of the Forms 8609 that are issued to X.

(b) *Election under section 42(b)(2)(A)(ii)(II) to use the appropriate percentage for the month tax-exempt bonds are issued*—(1) *Time and manner of making election.* In the case of any building to which section 42(h)(4)(B) applies, an election under section 42(b)(2)(A)(ii)(II) to use the appropriate percentage for the month tax-exempt bonds are issued must—

(i) Be in writing;

(ii) Reference section 42(b)(2)(A)(ii)(II);

(iii) Specify the percentage of the aggregate basis of the building and the land on which the building is located that is financed with the proceeds of obligations described in section 42(h)(4)(A) (tax-exempt bonds);

(iv) State the month in which the tax-exempt bonds are issued;

(v) State that the month in which the tax-exempt bonds are issued is the month elected for the appropriate percentage to be used for the building;

(vi) Be signed by the taxpayer; and

(vii) Be notarized by the 5th day following the end of the month in which the bonds are issued.

(2) *Bonds issued in more than one month.* If a building described in section 42(h)(4)(B) (substantially bond-financed building) is financed with tax-exempt bonds issued in more than one month, the taxpayer may elect the appropriate percentage for any month in which the bonds are issued. Once the election is made, the appropriate percentage elected applies for the building even if all bonds are not issued in that month. The requirements of this paragraph (b), including the time limitation contained in paragraph (b)(1)(vii) of this section, must also be met.

(3) *Limitations on appropriate percentage.* Under section 42(m)(2)(D), the credit allowable for a substantially bond- financed building is limited to the amount necessary to assure the project's feasibility. Accordingly, in making the determination under section 42(m)(2), an Agency may use an applicable percentage that is less, but not greater than, the appropriate percentage for the month the building is placed in service, or the month elected by the taxpayer under section 42(b)(2)(A)(ii)(II).

(4) *Procedures*—(i) *Taxpayer.* The taxpayer must provide the original notarized election statement to the Agency before the close of the 5th calendar day following the end of the month in which the bonds are issued. If an authority other than the Agency issues the tax-exempt bonds, the taxpayer must also give the Agency a signed statement from the issuing authority that certifies the information described in paragraphs (b)(1)(iii) and (iv) of this section. The taxpayer must also retain a copy of the election statement.

(ii) *Agency.* The Agency must retain the original of the election statement and a copy of the Form 8609 that reflects the election statement. The Agency must file an additional copy of the Form 8609 with the Agency's Form 8610 that reflects the calendar year the Form 8609 is issued.

[T.D. 8520, 59 FR 10071, Mar. 3, 1994, as amended by T.D. 9110, 69 FR 504, Jan. 6, 2004]

§ 1.42–9 For use by the general public.

(a) *General rule.* If a residential rental unit in a building is not for use by the general public, the unit is not eligible for a section 42 credit. A residential rental unit is for use by the general public if the unit is rented in a manner consistent with housing policy governing non-discrimination, as evidenced by rules or regulations of the Department of Housing and Urban Development (HUD) (24 CFR subtitle A and chapters I through XX). See HUD Handbook 4350.3 (or its successor). A copy of HUD Handbook 4350.3 may be requested by writing to: HUD, Directives Distribution Section, room B–100, 451 7th Street, SW., Washington, DC 20410.

(b) *Limitations.* Notwithstanding paragraph (a) of this section, if a residential rental unit is provided only for a member of a social organization or provided by an employer for its employees, the unit is not for use by the general public and is not eligible for credit under section 42. In addition, any residential rental unit that is part of a hospital, nursing home, sanitarium, lifecare facility, trailer park, or intermediate care facility for the mentally and physically handicapped is not for use by the general public and is not eligible for credit under section 42.

(c) *Treatment of units not for use by the general public.* The costs attributable to a residential rental unit that is not for use by the general public are not excludable from eligible basis by reason of the unit's ineligibility for the credit under this section. However, in calculating the applicable fraction, the unit is treated as a residential rental unit that is not a low-income unit.

[T.D. 8520, 59 FR 10073, Mar. 3, 1994]

§ 1.42–10 Utility allowances.

(a) *Inclusion of utility allowances in gross rent.* If the cost of any utility (other than telephone, cable television, or Internet) for a residential rental unit is paid directly by the tenant(s), and not by or through the owner of the building, the gross rent for that unit includes the applicable utility allowance determined under this section. For purposes of the preceding sentence, if the cost of a particular utility for a residential unit is paid pursuant to an actual-consumption submetering arrangement within the meaning of paragraph (e)(1) of this section, then that cost is treated as being paid directly by the tenant(s) and not by or through the owner of the building. This section only applies for purposes of determining gross rent under section 42(g)(2)(B)(ii) as to rent-restricted units.

(b) *Applicable utility allowances*—(1) *Buildings assisted by the Rural Housing Service.* If a building receives assistance from the Rural Housing Service (RHS-assisted building), the applicable utility allowance for all rent-restricted units in the building is the utility allowance determined under the method prescribed by the Rural Housing Service (RHS) for the building (whether or not the building or its tenants also receive other state or federal assistance).

(2) *Buildings with Rural Housing Service assisted tenants.* If any tenant in a building receives RHS rental assistance payments (RHS tenant assistance), the applicable utility allowance for all rent-restricted units in the building (including any units occupied by tenants receiving rental assistance payments from the Department of Housing and Urban Development (HUD)) is the applicable RHS utility allowance.

(3) *Buildings regulated by the Department of Housing and Urban Development.* If neither a building nor any tenant in the building receives RHS housing assistance, and the rents and utility allowances of the building are regulated by HUD (HUD-regulated buildings), the applicable utility allowance for all rent-restricted units in the building is the applicable HUD utility allowance.

(4) *Other buildings.* If a building is neither an RHS-assisted nor a HUD-regulated building, and no tenant in the building receives RHS tenant assistance, the applicable utility allowance for rent-restricted units in the building is determined under the following methods.

(i) *Tenants receiving HUD rental assistance.* The applicable utility allowance for any rent-restricted units occupied by tenants receiving HUD rental assistance payments (HUD tenant assistance) is the applicable Public Housing Authority (PHA) utility allowance established for the Section 8 Existing Housing Program.

(ii) *Other tenants*—(A) *General rule.* If none of the rules of paragraphs (b)(1), (2), (3), and (4)(i) of this section apply to determine the appropriate utility allowance for a rent-restricted unit, then the appropriate utility allowance for the unit is the applicable PHA utility allowance. However, if a local utility company estimate is obtained for any unit in the building in accordance with paragraph (b)(4)(ii)(B) of this section, that estimate becomes the appropriate utility allowance for all rent-restricted units of similar size and construction in the building. This local utility company estimate procedure is not available for and does not apply to units to which the rules of paragraphs (b) (1), (2), (3), or (4)(i) of this section apply. However, if a local utility company estimate is obtained for any unit in the building under paragraph (b)(4)(ii)(B) of this section, a State or local housing credit agency (Agency) provides a building owner with an estimate for any unit in a building under paragraph (b)(4)(ii)(C) of this section, a cost estimate is calculated using the HUD Utility Schedule Model under paragraph (b)(4)(ii)(D) of this section, or a cost estimate is calculated by an energy consumption model under paragraph (b)(4)(ii)(E) of this section, then the estimate under paragraph (b)(4)(ii)(B), (C), (D), or (E) becomes the applicable utility allowance for all rent-restricted units of similar size and construction in the building. Paragraphs (b)(4)(ii)(B), (C), (D), and (E) of this section do not apply to units to which the rules of paragraphs (b)(1), (2), (3), or (4)(i) of this section apply.

(B) *Utility company estimate.* Any interested party (including a low-income tenant, a building owner, or an Agency) may obtain a local utility company estimate for a unit. The estimate is obtained when the interested party receives, in writing, information from a local utility company providing the estimated cost of that utility for a unit of similar size and construction for the geographic area in which the building containing the unit is located. In the case of deregulated utility services, the interested party is required to obtain an estimate only from one utility company even if multiple companies can provide the same utility service to a unit. However, the utility company must offer utility services to the building in order for that utility company's rates to be used in calculating utility allowances. The estimate should include all component deregulated charges for providing the utility service. The local utility company estimate may be obtained by an interested party at any time during the building's extended use period (see section 42(h)(6)(D)) or, if the building does not have an extended use period, during the building's compliance period (see section 42(i)(1)). Unless the parties agree otherwise, costs incurred in obtaining the estimate are borne by the initiating party. The interested party that obtains the local utility company estimate (the initiating party) must retain the original of the utility company estimate and must furnish a copy of the local utility company estimate to the owner of the building (where the initiating party is not the owner), and the Agency that allocated credit to the building (where the initiating party is not the Agency). The owner of the building must make available copies of the utility company estimate to the tenants in the building.

(C) *Agency estimate.* A building owner may obtain a utility estimate for each unit in the building from the Agency that has jurisdiction over the building provided the Agency agrees to provide the estimate. The estimate is obtained when the building owner receives, in writing, information from the Agency providing the estimated per-unit cost of the utilities for units of similar size and construction for the geographic area in which the building containing the units is located. The Agency estimate may be obtained by a building owner at any time during the building's extended use period (see section 42(h)(6)(D)). Costs incurred in obtaining the estimate are borne by the building owner. In establishing an accurate utility allowance estimate for a particular building, an Agency (or an agent or other private contractor of the Agency that is a qualified professional within the meaning of paragraph (b)(4)(ii)(E) of this section) must take into account, among other things, local utility rates, property type, climate and degree-day variables by region in the State, taxes and fees on utility charges, building materials, and mechanical systems. If the Agency uses an agent or other private contractor to calculate the utility estimates, the agent or contractor and the owner must not be related within the meaning of section 267(b) or 707(b). An Agency may also use actual utility company usage data and rates for the building. However, use of the Agency estimate is limited to the building's consumption data for the twelve-month period ending no earlier than 60 days prior to the beginning of the 90-day period under paragraph (c)(1) of this section and utility rates used for the Agency estimate must be no older than the rates in place 60 days prior to the beginning of the 90-day period under paragraph (c)(1) of this section. In the case of newly constructed or renovated buildings with less than 12 months of consumption data, the Agency (or an agent or other private contractor of the Agency that is a qualified professional within the meaning of paragraph (b)(4)(ii)(E) of this section) may use consumption data for the 12-month period of units of similar size and construction in the geographic area in which the building containing the units is located.

(D) *HUD Utility Schedule Model.* A building owner may calculate a utility estimate using the "HUD Utility Schedule Model" that can be found on the Low-Income Housing Tax Credits page at *http://www.huduser.org/datasets/lihtc.html* (or successor URL). Utility rates used for the HUD Utility Schedule Model must be no older than the rates in place 60 days prior to the beginning of the 90-day period under paragraph (c)(1) of this section.

(E) *Energy consumption model.* A building owner may calculate utility estimates using an energy and water and sewage consumption and analysis model (energy consumption model). The energy consumption model must, at a minimum, take into account specific factors including, but not limited to, unit size, building orientation, design and materials, mechanical systems, appliances, characteristics of the building location, and available historical data. The utility consumption estimates must be calculated by a properly licensed engineer or other qualified professional. The qualified professional and the building owner must not be related within the meaning of section 267(b) or 707(b). If a qualified professional is not a properly licensed engineer and if the building owner wants to utilize that qualified professional to calculate utility consumption estimates, then the owner must obtain approval from the Agency that has jurisdiction over the building. Further, regardless of the type of qualified professional, the Agency may approve or disapprove of the energy consumption model or require information before permitting its use. In addition, utility rates used for the energy consumption model must be no older than the rates in place 60 days prior to the beginning of the 90-day period under paragraph (c)(1) of this section.

(c) *Changes in applicable utility allowance*—(1) *In general.* If, at any time during the building's extended use period (as defined in section 42(h)(6)(D)), the applicable utility allowance for units changes, the new utility allowance must be used to compute gross rents of the units due 90 days after the change (the 90-day period). For example, if rent must be lowered because a local utility company estimate is obtained that shows a higher utility cost than the otherwise applicable PHA utility allowance, the lower rent must be in effect for rent due at the end of the 90-day period. A building owner using a utility company estimate under paragraph (b)(4)(ii)(B) of this section, the HUD Utility Schedule Model under paragraph (b)(4)(ii)(D) of this section, or an energy consumption model under paragraph (b)(4)(ii)(E) of this section must submit copies of the utility estimates to the Agency that has jurisdiction over the building and make the estimates available to all tenants in the building at the beginning of the 90-day period before the utility allowances can be used in determining the gross rent of rent-restricted units. An Agency may require additional information from the owner during the 90-day period. Any utility estimates obtained under the Agency estimate under paragraph (b)(4)(ii)(C) of this section must also be made available to all tenants in the building at the beginning of the 90-day period. The building owner must pay for all costs incurred in obtaining the estimates under paragraphs (b)(4)(ii)(B), (C), (D), and (E) of this section and providing the estimates to the Agency and the tenants. The building owner is not required to review the utility allowances, or implement new utility allowances, until the building has achieved 90 percent occupancy for a period of 90 consecutive days or the end of the first year of the credit period, whichever is earlier.

(2) *Annual review.* A building owner must review at least once during each calendar year the basis on which utility allowances have been established and must update the applicable utility allowance in accordance with paragraph (c)(1) of this section. The review must take into account any changes to the building such as any energy conservation measures that affect energy consumption and changes in utility rates.

(d) *Record retention.* The building owner must retain any utility consumption estimates and supporting data as part of the taxpayer's records for purposes of §1.6001–1(a).

(e) *Actual-consumption submetering arrangements*—(1) *Definition.* For purposes of this section, an actual-consumption submetering arrangement for a utility in a residential unit possesses all of the following attributes:

(i) The utility consumed in the unit is described in paragraph (e)(1)(i)(A) of this section or in §1.42–10T(e)(1)(i)(B);

(A) The utility is purchased from or through a local utility company by the building owner (or its agent or other party acting on behalf of the building owner).

(B) [Reserved]. For further guidance see §1.42–10T(e)(1)(i)(B) through (e)(1)(i)(C)(*3*).

(ii) The tenants in the unit are billed for, and pay the building owner (or its agent or other party acting on behalf of the building owner) for, the unit's consumption of the utility;

(iii) The billed amount reflects the unit's actual consumption of the utility. In the case of sewerage charges, however, if the unit's sewerage charges are combined on the bill with water charges and the sewerage charges are determined based on the actual water consumption of the unit, then the bill is treated as reflecting the actual sewerage consumption of the unit; and

(iv) The rate at which the building owner bills for the utility satisfies the following requirements:

(A) To the extent that the utility consumed is described in paragraph (e)(1)(i)(A) of this section, the utility rate charged to the tenants of the unit does not exceed the rate incurred by the building owner for that utility; and

(B) To the extent that the utility consumed is described in §1.42–10T(e)(1)(i)(B), the utility rate charged to the tenants of the unit does not exceed the rate described in §1.42–10T(e)(1)(iv)(B).

(2) *Administrative fees.* If the owner charges a unit's tenants a fee for administering an actual-consumption submetering arrangement, the fee is not considered gross rent for purposes of section 42(g)(2). The preceding sentence, however, does not apply unless the fee is computed in the same manner for every unit receiving the same submetered utility service, nor does it apply to any amount by which the aggregate monthly fee or fees for all of the unit's utilities under one or more actual-consumption submetering arrangements exceed the greater of—

(i) Five dollars per month;

(ii) An amount (if any) designated by publication in the Internal Revenue Bulletin (see §601.601(d)(2)(ii) of this chapter); or

(iii) The lesser of—

(A) The dollar amount (if any) specifically prescribed under a State or local law; or

(B) A maximum amount (if any) designated by publication in the Internal Revenue Bulletin (see §601.601(d)(2)(ii) of this chapter).

[T.D. 8520, 59 FR 10073, Mar. 3, 1994, as amended by T.D. 9420, 73 FR 43867, July 29, 2008; T.D. 9755, 81 FR 11109, Mar. 3, 2016]

§1.42–10T Energy obtained directly from renewable sources (temporary).

(a) through (e)(1)(i)(A) [Reserved]. For further guidance see §1.42–10(a) through (e)(1)(i)(A).

(B) *Utility not purchased from or through a local utility company.* The utility is not described in §1.42–10(e)(1)(i)(A) and is produced from a renewable source (within the meaning of paragraph (e)(1)(i)(C) of this section).

(C) *Renewable source.* For purposes of paragraph (e)(1)(i)(B) of this section, a utility is produced from a renewable source if—

(*1*) It is energy that is produced from energy property described in section 48;

(*2*) It is energy that is produced from property that is part of a facility described in section 45(d)(1) through (4), (6), (9), or (11); or

(*3*) It is a utility that is described in guidance published for this purpose in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii) of this chapter).

(ii) through (iv)(A) [Reserved]. For further guidance see § 1.42–10(e)(1)(ii) through (e)(1)(iv)(A).

(B) The rate described in this paragraph (e)(1)(iv)(B) is the rate at which the local utility company would have charged the tenants in the unit for the utility if that entity had provided it to them.

(2) [Reserved]

(f) *Date of applicability.* This section applies to a building owner's taxable years beginning on or after March 3, 2016. A building owner may apply the provisions of this section to the building owner's taxable years beginning before March 3, 2016.

(g) *Expiration date.* The applicability of this section expires on March 1, 2019.

[T.D. 9755, 81 FR 11110, Mar. 3, 2016]

§ 1.42–11 Provision of services.

(a) *General rule.* The furnishing to tenants of services other than housing (whether or not the services are significant) does not prevent the units occupied by the tenants from qualifying as residential rental property eligible for credit under section 42. However, any charges to low-income tenants for services that are not optional generally must be included in gross rent for purposes of section 42(g).

(b) *Services that are optional*—(1) *General rule.* A service is optional if payment for the service is not required as a condition of occupancy. For example, for a qualified low-income building with a common dining facility, the cost of meals is not included in gross rent for purposes of section 42(g)(2)(A) if payment for the meals in the facility is not required as a condition of occupancy and a practical alternative exists for tenants to obtain meals other than from the dining facility.

(2) *Continual or frequent services.* If continual or frequent nursing, medical, or psychiatric services are provided, it is presumed that the services are not optional and the building is ineligible for the credit, as is the case with a hospital, nursing home, sanitarium, lifecare facility, or intermediate care facility for the mentally and physically handicapped. See also § 1.42–9(b).

(3) *Required services*—(i) *General rule.* The cost of services that are required as a condition of occupancy must be included in gross rent even if federal or state law requires that the services be offered to tenants by building owners.

(ii) *Exceptions*—(A) *Supportive services.* Section 42(g)(2)(B)(iii) provides an exception for certain fees paid for supportive services. For purposes of section 42(g)(2)(B)(iii), a supportive service is any service provided under a planned program of services designed to enable residents of a residential rental property to remain independent and avoid placement in a hospital, nursing home, or intermediate care facility for the mentally or physically handicapped. For a building described in section 42(i)(3)(B)(iii) (relating to transitional housing for the homeless) or section 42(i)(3)(B)(iv) (relating to single-room occupancy), a supportive service includes any service provided to assist tenants in locating and retaining permanent housing.

(B) *Specific project exception.* Gross rent does not include the cost of mandatory meals in any federally-assisted project for the elderly and handicapped (in existence on or before January 9, 1989) that is authorized by 24 CFR 278 to provide a mandatory meals program.

[T.D. 8520, 59 FR 10074, Mar. 3, 1994, as amended by T.D. 8859, 65 FR 2328, Jan. 14, 2000]

§ 1.42–12 Effective dates and transitional rules.

(a) *Effective dates*—(1) *In general.* Except as provided in paragraphs (a)(2) and (a)(3) of this section, the rules set forth in §§ 1.42–6 and 1.42–8 through 1.42–12 are applicable on May 2, 1994. However, binding agreements, election statements, and carryover allocation documents entered into before May 2, 1994, that follow the guidance set forth in Notice 89–1, 1989–1 C.B. 620 (*see* § 601.601(d)(2)(ii)(b) of this chapter) need not be changed to conform to the rules set forth in §§ 1.42–6 and 1.42–8 through 1.42–12.

(2) *Community Renewal Tax Relief Act of 2000*—(i) *In general.* Section 1.42–6 (a), (b)(4)(iii) *Example 1* and *Example 2,* (c), (d)(2)(viii), and (e)(2) are applicable for housing credit dollar amounts allocated after January 6, 2004. However, the rules in § 1.42–6 (a), (b)(4)(iii) *Example 1* and *Example 2,* (c), (d)(2)(viii), and (e)(2) may be applied by Agencies and taxpayers for housing credit dollar amounts allocated after December 31, 2000, and on or before January 6, 2004. Otherwise, subject to the applicable effective dates of the corresponding statutory provisions, the rules that apply for housing credit dollar amounts allocated on or before January 6, 2004, are contained in § 1.42–6 in effect on and before January 6, 2004 (see 26 CFR part 1 revised as of April 1, 2003).

(3) *Electronic filing simplification changes.* Sections 1.42–6(d)(4) and 1.42–8(a)(6)(i), (a)(6)(ii), (a)(7) Example 1 and Example 2, (b)(4)(i), and (b)(4)(ii) are applicable for forms filed after January 6, 2004. The rules that apply for forms filed on or before January 6, 2004, are contained in § 1.42–6 and § 1.42–8 in effect on and before January 6, 2004 (see 26 CFR part 1 revised as of April 1, 2003).

(4) *Utility allowances.* The first sentence in § 1.42–10(a), § 1.42–10(b)(1), (2), (3), and (4), the last two sentences in § 1.42–10(b)(4)(ii)(A), the third, fourth, and fifth sentences in § 1.42–10(b)(4)(ii)(B), § 1.42–10(b)(4)(ii)(C), (D), and (E), and § 1.42–10(c) and (d) are applicable to a building owner's taxable years beginning on or after July 29, 2008. Taxpayers may rely on these provisions before the beginning of the building owner's taxable year beginning on or after July 29, 2008 provided that any utility allowances calculated under these provisions are effective no earlier than the first day of the building owner's taxable year beginning on or after July 29, 2008. The utility allowances provisions that apply to taxable years beginning before July 29, 2008 are contained in § 1.42–10 (see 26 CFR part 1 revised as of April 1, 2008).

(5) *Additional effective dates affecting utility allowances.* (i) The following provisions apply to a building owner's taxable years beginning on or after March 3, 2016—

(A) The second sentence in § 1.42–10(a);

(B) Section 1.42–10(b)(3);

(C) The first sentence in § 1.42–10(b)(4)(ii)(A);

(D) Section 1.42–10(b)(4)(ii)(E); and

(E) Section 1.42–10(e).

(ii) A building owner may apply these provisions to the building owner's taxable years beginning before March 3, 2016. Otherwise, the utility allowances provisions that apply to taxable years beginning before March 3, 2016 are contained in § 1.42–10 (see 26 CFR part 1 revised as of April 1, 2015).

(b) *Prior periods.* Notice 89–1, 1989–1 C.B. 620 and Notice 89–6, 1989–1 C.B. 625 (see § 601.601(d)(2)(ii)(*b*) of this chapter) may be applied for periods prior to May 2, 1994.

(c) *Carryover allocations.* The rule set forth in § 1.42–6(d)(4)(ii) relating to the requirement that state and local housing agencies file Schedule A (Form 8610), ''Carryover Allocation of the Low-Income Housing Credit,'' is applicable for carryover allocations made after December 31, 1999.

[T.D. 8520, 59 FR 10074, Mar. 3, 1994; 59 FR 15501, Apr. 1, 1994, as amended by T.D. 8859, 65 FR 2328, Jan. 14, 2000; T.D. 9110, 69 FR 504, Jan. 6, 2004; T.D. 9420, 73 FR 43868, July 29, 2008; T.D. 9755, 81 FR 11110, Mar. 3, 2016]

§ 1.42–13 Rules necessary and appropriate; housing credit agencies' correction of administrative errors and omissions.

(a) *Publication of guidance.* Under section 42(n), the Secretary has authority to prescribe regulations as may be necessary or appropriate to carry out the purposes of section 42. The Secretary may also provide guidance through various publications in the Internal Revenue Bulletin. (See § 601.601(d)(2)(ii)(*b*) of this chapter.)

(b) *Correcting administrative errors and omissions*—(1) *In general.* An Agency may correct an administrative error or omission with respect to allocations and recordkeeping, as described in paragraph (b)(2) of this section, within a reasonable period after the Agency discovers the administrative error or omission. Whether a correction is made within a reasonable period depends on the facts and circumstances of each situation. Except as provided in paragraph (b)(3)(iii) of this section, an Agency need not obtain the prior approval of the Secretary to correct an administrative error or omission, if the correction is made in accordance with paragraph (b)(3)(i) of this section. The administrative errors and omissions to which this paragraph (b) applies are strictly limited to those described in paragraph (b)(2) of this section, and, thus, do not include, for example, any misinterpretation of the applicable rules and regulations under section 42. Accordingly, an Agency's allocation of a particular calendar year's low-income housing credit dollar amount made after the close of that calendar year, or the use of an incorrect population amount in calculating a State's housing credit ceiling for a calendar year are not administrative errors that can be corrected under this paragraph (b).

(2) *Administrative errors and omissions described.* An administrative error or omission is a mistake that results in a document that inaccurately reflects the intent of the Agency at the time the document is originally completed or, if the mistake affects a taxpayer, a document that inaccurately reflects the intent of the Agency and the affected taxpayer at the time the document is originally completed. Administrative errors and omissions described in this paragraph (b)(2) include the following—

(i) A mathematical error;

(ii) An entry on a document that is inconsistent with another entry on the same or another document regarding the same property, or taxpayer;

(iii) A failure in tracking the housing credit dollar amount an Agency has allocated (or that remains to be allocated) in the current calendar year (e.g., a failure to include in its State housing credit ceiling a previously allocated credit dollar amount that has been returned by a taxpayer);

(iv) An omission of information that is required on a document; and

(v) Any other type of error or omission identified by guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter) as an administrative error or omission covered by this paragraph (b).

(3) *Procedures for correcting administrative errors or omissions*—(i) *In general.* An Agency's correction of an administrative error or omission, as described in paragraph (b)(2) of this section, must amend the document so that the corrected document reflects the original intent of the Agency, or the Agency and the affected taxpayer, and complies with applicable rules and regulations under section 42.

(ii) *Specific procedures.* If a document corrects a document containing an administrative error or omission that has not yet been filed with the Internal Revenue Service, the Agency, or the Agency and the affected taxpayer, should complete and file the corrected document as the original. When a document containing an administrative error or omission has already been filed with the Service, the Agency, or the Agency and the affected taxpayer, should refile a copy of the document containing the administrative error or omission, and prominently and clearly note the correction thereon or on an attached new document. The Agency should indicate at the top of the document(s) that the correction is being made under § 1.42–13 of the Income Tax Regulations.

(iii) *Secretary's prior approval required.* Except as provided in paragraph (b)(3)(vi) of this section, an Agency must obtain the Secretary's prior approval to correct an administrative error or omission, as described in paragraph (b)(2) of this section, if the correction is not made before the close of the calendar year of the error or omission and the correction—

(A) Is a numerical change to the housing credit dollar amount allocated for the building or project;

(B) Affects the determination of any component of the State's housing credit ceiling under section 42(h)(3)(C); or

(C) Affects the State's unused housing credit carryover that is assigned to the Secretary under section 42(h)(3)(D).

(iv) *Requesting the Secretary's approval.* To obtain the Secretary's approval under paragraph (b)(3)(iii) of this section, an Agency must submit a request for the Secretary's approval within a reasonable period after discovering the administrative error or omission, and must agree to any conditions that may be required by the Secretary under paragraph (b)(3)(v) of this section. When requesting the Secretary's approval, the Agency, or the Agency and the affected taxpayer, must file an application that complies with the requirements of this paragraph (b)(3)(iv). For further information on the application procedure see Rev. Proc. 93–1, 1993–1 I.R.B. 10 (or any subsequent applicable revenue procedure). (See §601.601(d)(2)(ii)(*b*) of this chapter.) The application requesting the Secretary's approval must contain the following information—

(A) The name, address, and identification number of each affected taxpayer;

(B) The Building Identification Number (B.I.N.) and address of each building or project affected by the administrative error or omission;

(C) A statement explaining the administrative error or omission and the intent of the Agency, or of the Agency and the affected taxpayer, when the document was originally completed;

(D) Copies of any supporting documentation;

(E) A statement explaining the effect, if any, that a correction of the administrative error or omission would have on the housing credit dollar amount allocated for any building or project; and

(F) A statement explaining the effect, if any, that a correction of the administrative error or omission would have on the determination of the components of the State's housing credit ceiling under section 42(h)(3)(C) or on the State's unused housing credit carryover that is assigned to the Secretary under section 42(h)(3)(D).

(v) *Agreement to conditions.* To obtain the Secretary's approval under paragraph (b)(3)(iii) of this section, an Agency, or the Agency and the affected taxpayer, must agree to the conditions the Secretary considers appropriate.

(vi) *Secretary's automatic approval.* The Secretary grants automatic approval to correct an administrative error or omission described in paragraph (b)(2) of this section if—

(A) The correction is not made before the close of the calendar year of the error or omission and the correction is a numerical change to the housing credit dollar amount allocated for the building or multiple-building project;

(B) The administrative error or omission resulted in an allocation document (the Form 8609, ''Low-Income Housing Credit Allocation Certification,'' or the allocation document under the requirements of section 42(h)(1)(E) or (F), and §1.42–6(d)(2)) that either did not accurately reflect the number of buildings in a project (for example, an allocation document for a 10-building project only references 8 buildings instead of 10 buildings), or the correct information (other than the amount of credit allocated on the allocation document);

(C) The administrative error or omission does not affect the Agency's ranking of the building(s) or project and the total amount of credit the Agency allocated to the building(s) or project; and

(D) The Agency corrects the administrative error or omission by following the procedures described in paragraph (b)(3)(vii) of this section.

(vii) *How Agency corrects errors or omissions subject to automatic approval.* An Agency corrects an administrative error or omission described in paragraph (b)(3)(vi) of this section by—

(A) Amending the allocation document described in paragraph (b)(3)(vi)(B) of this section to correct the administrative error or omission. The Agency will indicate on the amended allocation document that it is making the ''correction under §1.42–13(b)(3)(vii).'' If correcting the allocation document requires including any additional B.I.N.(s) in the document, the document must include any B.I.N.(s) already existing for buildings in the project. If possible, the additional B.I.N.(s) should be sequentially numbered from the existing B.I.N.(s);

(B) Amending, if applicable, the Schedule A (Form 8610), ''Carryover Allocation of the Low-Income Housing Credit,'' and attaching a copy of this schedule to Form 8610, ''Annual Low-Income Housing Credit Agencies Report,'' for the year the correction is made. The Agency will indicate on the schedule that it is making the "correction under § 1.42–13(b)(3)(vii)." For a carryover allocation made before January 1, 2000, the Agency must complete Schedule A (Form 8610), and indicate on the schedule that it is making the "correction under § 1.42–13(b)(3)(vii)";

(C) Amending, if applicable, the Form 8609 and attaching the original of this amended form to Form 8610 for the year the correction is made. The Agency will indicate on the Form 8609 that it is making the "correction under § 1.42–13(b)(3)(vii)"; and

(D) Mailing or otherwise delivering a copy of any amended allocation document and any amended Form 8609 to the affected taxpayer.

(viii) *Other approval procedures.* The Secretary may grant automatic approval to correct other administrative errors or omissions as designated in one or more documents published either in the FEDERAL REGISTER or in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter).

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

Example 1. Individual B applied to Agency X for a reservation of a low-income housing credit dollar amount for a building that is part of a low-income housing project. When applying for the low-income housing credit dollar amount, B informed Agency X that B intended to form Partnership Y to finance the project. After receiving the reservation letter and prior to receiving an allocation, B formed Partnership Y and sold partnership interests to a number of limited partners. B contributed the low-income housing project to Partnership Y in exchange for a partnership interest. B and Partnership Y informed Agency X of the ownership change. When actually allocating the housing credit dollar amount, Agency X sent Partnership Y a document listing B, rather than Partnership Y, as the building's owner. Partnership Y promptly notified Agency X of the error. After reviewing related documents, Agency X determined that it had incorrectly listed B as the building's owner on the allocation document. Since the parties originally intended that Partnership Y would receive the allocation as the owner of the building, Agency X may correct the error without obtaining the Secretary's approval, and insert Partnership Y as the building's owner on the allocation document.

Example 2. Agency Y allocated a lower low-income housing credit dollar amount for a low-income housing building than Agency Y originally intended. After the close of the calendar year of the allocation, B, the building's owner, discovered the error and promptly notified Agency Y. Agency Y reviewed relevant documents and agreed that an error had occurred. Agency Y and B must apply, as provided in paragraph (b)(3)(iv) of this section, for the Secretary's approval before Agency Y may correct the error.

(d) *Effective date.* This section is effective February 24, 1994. However, an Agency may elect to apply these regulations to administrative errors or omissions that occurred before the publication of these regulations. Any reasonable method used by a State or local housing credit agency to correct an administrative error or omission prior to February 24, 1994, will be considered proper, provided that the method is consistent with the rules of section 42. Paragraphs (b)(3)(vi), (vii), and (viii) of this section are effective January 14, 2000.

[T.D. 8521, 59 FR 8861, Feb. 24, 1994, as amended by T.D. 8859, 65 FR 2328, Jan. 14, 2000]

§ 1.42–14 Allocation rules for post-2000 State housing credit ceiling amount.

(a) *State housing credit ceiling*—(1) *In general.* The State housing credit ceiling for a State for any calendar year after 2000 is comprised of four components. The four components are—

(i) The unused State housing credit ceiling, if any, of the State for the preceding calendar year (the unused carryforward component);

(ii) The greater of—

(A) $1.75 ($1.50 for calendar year 2001) multiplied by the State population; or

(B) $2,000,000 (the population component);

(iii) The amount of State housing credit ceiling returned in the calendar year (the returned credit component); plus

(iv) The amount, if any, allocated to the State by the Secretary under section 42(h)(3)(D) from a national pool of unused credit (the national pool component).

(2) *Cost-of-living adjustment*—(i) *General rule.* For any calendar year after 2002, the $2,000,000 and $1.75 amounts in paragraph (a)(1)(ii) of this section are each increased by an amount equal to—

(A) The dollar amount; multiplied by

(B) The cost-of-living adjustment determined under section 1(f)(3) for the calendar year by substituting ''calendar year 2001'' for ''calendar year 1992'' in section 1(f)(3)(B).

(ii) *Rounding.* Any increase resulting from the application of paragraph (a)(2)(i) of this section which, in the case of the $2,000,000 amount, is not a multiple of $5,000, is rounded to the next lowest multiple of $5,000, and which, in the case of the $1.75 amount, is not a multiple of 5 cents, is rounded to the next lowest multiple of 5 cents.

(b) *The unused carryforward component.* The unused carryforward component of the State housing credit ceiling for any calendar year is the unused State housing credit ceiling, if any, of the State for the preceding calendar year. The unused State housing credit ceiling for any calendar year is the excess, if any, of—

(1) The sum of the population, returned credit, and national pool components for the calendar year; over

(2) The aggregate housing credit dollar amount allocated for the calendar year reduced by the housing credit dollar amounts allocated from the unused carryforward component for the calendar year.

(c) *The population component.* The population component of the State housing credit ceiling of a State for any calendar year is determined pursuant to section 146(j). Thus, a State's population for any calendar year is determined by reference to the most recent census estimate, whether final or provisional, of the resident population of the State released by the Bureau of the Census before the beginning of the calendar year for which the State's housing credit ceiling is set. Unless otherwise prescribed by applicable revenue procedure, determinations of population are based on the most recent estimates of population contained in the Bureau of the Census publication, *Current Population Report, Series P–25; Population Estimates and Projections, Estimates of the Population of States.* For convenience, the Internal Revenue Service publishes the population estimates annually in the Internal Revenue Bulletin. (See § 601.601(d)(2)(ii)(*b*)).

(d) *The returned credit component*—(1) *In general.* The returned credit component of the State housing credit ceiling of a State for any calendar year equals the housing credit dollar amount returned during the calendar year that was validly allocated within the State in a prior calendar year to any project that does not become a qualified low-income housing project within the period required by section 42, or as required by the terms of the allocation. The returned credit component also includes credit allocated in a prior calendar year that is returned as a result of the cancellation of an allocation by mutual consent or by an Agency's determination that the amount allocated is not necessary for the financial feasibility of the project. For purposes of this section, credit is allocated within a State if it is allocated from the State's housing credit ceiling by an Agency of the State or of a constitutional home rule city in the State.

(2) *Limitations and special rules.* The following limitations and special rules apply for purposes of this paragraph (d).

(i) *General limitations.* Notwithstanding any other provision of this paragraph (d), returned credit does not include any credit that was—

(A) Allocated prior to calendar year 1990;

(B) Allowable under section 42(h)(4) (relating to the portion of credit attributable to eligible basis financed by certain tax-exempt bonds under section 103); or

(C) Allocated during the same calendar year that it is received back by the Agency.

(ii) *Credit period limitation.* Notwithstanding any other provision of this paragraph (d), an allocation of credit may not be returned any later than 180 days following the close of the first taxable year of the credit period for the building that received the allocation. After this date, credit that might otherwise be returned expires, and cannot be returned to or reallocated by any Agency.

(iii) *Three-month rule for returned credit.* An Agency may, in its discretion, treat any portion of credit that is returned from a project after September 30 of a calendar year and that is not reallocated by the close of the calendar year as returned on January 1 of the succeeding calendar year. In this case, the returned credit becomes part of the returned credit component of the State housing credit ceiling for the succeeding calendar year. Any portion of credit that is returned from a project after September 30 of a calendar year that is reallocated by the close of the calendar year is treated as part of the returned credit component of the State housing credit ceiling for the calendar year that the credit was returned.

(iv) *Returns of credit.* Subject to the limitations of paragraphs (d)(2) (i) and (ii) of this section, credit is returned to the Agency in the following instances in the manner described in paragraph (d)(3) of this section.

(A) *Building not qualified within required time period.* If a building is not a qualified building within the time period required by section 42, it loses its credit allocation and the credit is returned. For example, a building is not qualified within the required time period if it is not placed in service within the period required by section 42 or if the project of which the building is a part fails to meet the minimum set-aside requirements of section 42(g)(1) by the close of the first year of the credit period. Also, a building that has received a post-June 30 carryover allocation is not qualified within the required time period if the taxpayer does not meet the 10 percent basis requirement by the date that is 6 months after the date the allocation was made (as described in § 1.42–6(a)(2)(ii)).

(B) *Noncompliance with terms of the allocation.* If a building does not comply with the terms of its allocation, it loses the credit allocation and the credit is returned. The terms of an allocation are the written conditions agreed to by the Agency and the allocation recipient in the allocation document.

(C) *Mutual consent.* If the Agency and the allocation recipient cancel an allocation of an amount of credit by mutual consent, that amount of credit is returned.

(D) *Amount not necessary for financial feasibility.* If an Agency determines under section 42(m)(2) that an amount of credit allocated to a project is not necessary for the financial feasibility of the project and its viability as a qualified low-income housing project throughout the credit period, that amount of credit is returned.

(3) *Manner of returning credit*—(i) *Taxpayer notification.* After an Agency determines that a building or project no longer qualifies under paragraph (d)(2)(iv)(A), (B), or (D) of this section for all or part of the allocation it received, the Agency must provide written notification to the allocation recipient, or its successor in interest, that all or part of the allocation is no longer valid. The notification must also state the amount of the allocation that is no longer valid. The date of the notification is the date the credit is returned to the Agency. If an allocation is cancelled by mutual consent under paragraph (d)(2)(iv)(C) of this section, there must be a written agreement signed by the Agency, and the allocation recipient, or its successor in interest, indicating the amount of the allocation that is returned to the Agency. The effective date of the agreement is the date the credit is returned to the Agency.

(ii) *Internal Revenue Service notification.* If a credit is returned within 180 days following the close of the first taxable year of a building's credit period as provided in paragraph (d)(2)(ii) of this section, and a Form 8609, *Low-Income Housing Credit Allocation Certification*, has been issued for the building, the Agency must notify the Internal Revenue Service that the credit has been returned. If only part of the credit has been returned, this notification requirement is satisfied when the Agency attaches to an amended Form 8610, *Annual Low- Income Housing Credit Agencies Report*, the original of an amended Form 8609 reflecting the correct amount of credit attributed to the building together with an explanation for the filing of the amended Forms. The Agency must send a copy of the amended Form 8609 to the taxpayer that owns the building. If the building is not issued an amended Form 8609 because all of the credit allocated to the building is returned, notification to the Internal Revenue Service is satisfied by following the requirements prescribed in § 1.42–5(e)(3) for filing a Form 8823, *Low-Income Housing Credit Agencies Report of Noncompliance*.

(e) *The national pool component.* The national pool component of the State housing credit ceiling of a State for any calendar year is the portion of the National Pool allocated to the State by the Secretary for the calendar year. The national pool component for any calendar year is zero unless a State is a *qualified State.* (See paragraph (i) of this section for rules regarding the National Pool and the description of a qualified State.) A national pool component credit that is allocated during a calendar year and returned after the close of the calendar year may qualify as part of the returned credit component of the State housing credit ceiling for the calendar year that the credit is returned.

(f) *When the State housing credit ceiling is determined.* For purposes of accounting for the State housing credit ceiling on Form 8610 and for purposes of determining the set-aside apportionment for projects involving qualified nonprofit organizations described in section 42(h)(5) and §1.42–1T(c)(5), the State housing credit ceiling for any calendar year is determined at the close of the calendar year.

(g) *Stacking order.* Credit is treated as allocated from the various components of the State housing credit ceiling in the following order. The first credit allocated for any calendar year is treated as credit from the unused carryforward component of the State housing credit ceiling for the calendar year. After all of the credit in the unused carryforward component has been allocated, any credit allocated is treated as allocated from the sum of the population, returned credit, and national pool components of the State housing credit ceiling.

(h) *Nonprofit set-aside*—(1) *Determination of set-aside.* Under section 42(h)(5) and §1.42–1T(c)(5), at least 10 percent of a State housing credit ceiling in any calendar year must be set aside exclusively for projects involving qualified nonprofit organizations (the nonprofit set-aside). However, credit allocated from the nonprofit set-aside in a calendar year and returned in a subsequent calendar year does not retain its nonprofit set-aside character. The credit becomes part of the returned credit component of the State housing credit ceiling for the calendar year that the credit is returned and must be included in determining the nonprofit set-aside of the State housing credit ceiling for that calendar year. Similarly, credit amounts that are not allocated from the nonprofit set-aside in a calendar year and are returned in a subsequent calendar year become part of the returned credit component of the State housing credit ceiling for that year and are also included in determining the set-aside for that year.

(2) *Allocation rules.* An Agency may allocate credit from any component of the State housing credit ceiling as part of the nonprofit set-aside and need not reserve 10 percent of each component for the nonprofit set-aside. Thus, an Agency may satisfy the nonprofit set-aside requirement of section 42(h)(5) and §1.42–1T(c)(5) in any calendar year by setting aside for allocation an amount equal to at least 10 percent of the total State housing credit ceiling for the calendar year.

(i) *National Pool*—(1) *In general.* The unused housing credit carryover of a State for any calendar year is assigned to the Secretary for inclusion in a national pool of unused housing credit carryovers (National Pool) that is reallocated among qualified States the succeeding calendar year. The assignment to the Secretary is made on Form 8610.

(2) *Unused housing credit carryover.* The unused housing credit carryover of a State for any calendar year is the excess, if any, of—

(i) The unused carryforward component of the State housing credit ceiling for the calendar year; over

(ii) The total housing credit dollar amount allocated for the calendar year.

(3) *Qualified State*—(i) *In general.* The term *qualified State* means, with respect to any calendar year, any State that has allocated its entire State housing credit ceiling for the preceding calendar year and for which a request is made by the State, not later than May 1 of the calendar year, to receive an allocation of credit from the National Pool for that calendar year. Except as provided in paragraph (i)(3)(ii) of this section, a State is not a qualified State in a calendar year if there remains any

unallocated credit in its State housing credit ceiling at the close of the preceding calendar year that was apportioned to any Agency within the State for the calendar year.

(ii) *Exceptions*—(A) *De minimis amount*. If the amount remaining unallocated at the close of a calendar year is only a de minimis amount of credit, the State is a qualified State eligible to participate in the National Pool. For that purpose, a credit amount is de minimis if it does not exceed 1 percent of the aggregate State housing credit ceiling of the State for the calendar year.

(B) *Other circumstances*. Pursuant to the authority under section 42(n), the Internal Revenue Service may determine that a State is a qualified State eligible to participate in the National Pool even though the State's unallocated credit is in excess of the 1 percent safe harbor set forth in paragraph (A) of this section. The Internal Revenue Service will make this determination based on all the facts and circumstances, weighing heavily the interests of the States who would otherwise qualify for the National Pool. The Internal Revenue Service will generally grant relief under this paragraph only where a State's unallocated credit is not substantial.

(iii) *Time and manner for making request*. For further guidance as to the time and manner for making a request of housing credit dollar amounts from the National Pool by a qualified State, see Rev. Proc. 92–31, 1992–1 C.B. 775. (See 601.601(d)(2)(ii)(*b*)).

(4) *Formula for determining the National Pool*. The amount allocated to a qualified State in any calendar year is an amount that bears the same ratio to the aggregate unused housing credit carryovers of all States for the preceding calendar year as that State's population for the calendar year bears to the population of all qualified States for the calendar year.

(j) *Coordination between Agencies*. The Agency responsible for filing Form 8610 on behalf of all Agencies within a State and making any request on behalf of the State for credit from the National Pool (the Filing Agency) must coordinate with each Agency within the State to ensure that the various requirements of this section are complied with. For example, the Filing Agency of a State must ensure that all Agencies within the State that were apportioned a credit amount for the calendar year have allocated all of their respective credit amounts for the calendar year before the Filing Agency can make a request on behalf of the State for a distribution of credit from the National Pool.

(k) *Example*. (1) The operation of the rules of this section is illustrated by the following examples. Unless otherwise stated in an example, Agency A is the sole Agency authorized to make allocations of housing credit dollar amounts in State M, all of Agency A's allocations are valid, and for calendar year 2003, Agency A has available for allocation a State housing credit ceiling consisting of the following housing credit dollar amounts:

A. Unused carryforward component	$50
B. Population component	110
C. Returned credit component	10
D. National pool component	0
Total	170

(2) In addition, the $10 of returned credit component was returned before October 1, 2003.

Example 1: (i) *Additional facts*. By the close of 2003, Agency A had allocated $80 of the State M housing credit ceiling. Of the $80 allocated, $17 was allocated to projects involving qualified nonprofit organizations.

(ii) *Application of stacking rules*. The $80 of allocated credit is first treated as allocated from the unused carryforward component of the State housing credit ceiling. The $80 of allocated credit exceeds the $50 attributable to the unused carryforward component by $30. Because the unused carryforward component is fully utilized no credit will be forfeited by State M to the 2004 National Pool. The remaining $30 of allocated credit will next be treated as allocated from the $120 in credit determined by aggregating the population, returned credit, and national pool components ($110 + 10 + 0 = $120). The $90 of unallocated credit remaining in State M's 2003 State housing credit ceiling ($120 − 30 = $90) represents the unused carryforward component of State M's 2004 State housing credit ceiling. Under paragraph (i)(3) of this section, State M does not qualify for credit from the 2004 National Pool.

(iii) *Nonprofit set-aside*. Agency A allocated exactly the amount of credit to projects involving qualified nonprofit organizations as necessary to meet the nonprofit set-aside requirement ($17, 10% of the $170 ceiling).

Example 2: (i) *Additional facts.* By the close of 2003, Agency A had allocated $40 of the State M housing credit ceiling. Of the $40 allocated, $20 was allocated to projects involving qualified nonprofit organizations.

(ii) *Application of stacking rules.* The $40 of allocated credit is first treated as allocated from the unused carryforward component of the State housing credit ceiling. Because the $40 of allocated credit does not exceed the $50 attributable to the unused carryforward component, the remaining components of the State housing credit ceiling are unaffected. The $10 remaining in the unused carryforward component is assigned to the Secretary for inclusion in the 2004 National Pool. The $120 in credit determined by aggregating the population, returned credit, and national pool components becomes the unused carryforward component of State M's 2004 State housing credit ceiling. Under paragraph (i)(3) of this section, State M does not qualify for credit from the 2004 National Pool.

(iii) *Nonprofit set-aside.* Agency A allocated $3 more credit to projects involving qualified nonprofit organizations than necessary to meet the nonprofit set-aside requirement. This does not reduce the application of the 10% nonprofit set-aside requirement to the State M housing credit ceiling for calendar year 2004.

Example 3: (i) *Additional fact.* None of the applications for credit that Agency A received for 2003 are for projects involving qualified nonprofit organizations.

(ii) *Nonprofit set-aside.* Because at least 10% of the State housing credit ceiling must be set aside for projects involving a qualified nonprofit organization, Agency A can allocate only $153 of the $170 State housing credit ceiling for calendar year 2003 ($170 −17 = $153). If Agency A allocates $153 of credit, the credit is treated as allocated $50 from the unused carryforward component and $103 from the sum of the population, returned credit, and national pool components. The $17 of unallocated credit that is set aside for projects involving qualified nonprofit organizations becomes the unused carryforward component of State M's 2004 State housing credit ceiling. Under paragraph (i)(3) of this section, State M does not qualify for credit from the 2004 National Pool.

Example 4: (i) *Additional facts.* The $10 of returned credit component was returned prior to October 1, 2003. However, a $40 credit that had been allocated in calendar year 2002 to a project involving a qualified nonprofit organization was returned to the Agency by a mutual consent agreement dated November 15, 2003. By the close of 2003, Agency A had allocated $170 of the State M's housing credit ceiling, including $17 of credit to projects involving qualified nonprofit organizations.

(ii) *Effect of three-month rule.* Under the three-month rule of paragraph (d)(2)(iii) of this section, Agency A may treat all or part of the $40 of previously allocated credit as returned on January 1, 2004. If Agency A treats all of the $40 amount as having been returned in calendar year 2004, the State M housing credit ceiling for 2003 is $170. This entire amount, including the $17 nonprofit set-aside, has been allocated in 2003. Under paragraph (i)(3) of this section, State M qualifies for the 2004 National Pool.

(iii) *If three-month rule not used.* If Agency A treats all of the $40 of previously allocated credit as returned in calendar year 2003, the State housing credit ceiling for the 2003 calendar year will be $210 of which $50 will be attributable to the returned credit component ($10 + $40 = $50). Because credit amounts allocated to a qualified nonprofit organization in a prior calendar year that are returned in a subsequent calendar year do not retain their nonprofit character, the nonprofit set-aside for calendar year 2003 is $21 (10% of the $210 State housing credit ceiling). The $170 that Agency A allocated during 2003 is first treated as allocated from the unused carryforward component of the State housing credit ceiling. The $170 of allocated credit exceeds the $50 attributable to the unused carryforward component by $120. Because the unused carryforward component is fully utilized no credit will be forfeited by State M to the 2004 National Pool. The remaining $120 of allocated credit will next be treated as allocated from the $160 in credit determined by aggregating the population, returned credit, and national pool components ($110 + 50 + 0 = $160). The $40 of unallocated credit (which includes $4 of unallocated credit from the $21 nonprofit set-aside) remaining in State M's 2003 housing credit ceiling ($160 − 120 = $40) represents the unused carryforward component of State M's 2004 housing credit ceiling. Under paragraph (i)(3) of this section, State M does not qualify for credit from the 2004 National Pool.

(l) *Effective dates*—(1) *In general.* Except as provided in paragraph (l)(2) of this section, the rules set forth in §1.42–14 are applicable on January 1, 1994.

(2) *Community Renewal Tax Relief Act of 2000 changes.* Paragraphs (a), (b), (c), (e), (i)(2) and (k) of this section are applicable for housing credit dollar amounts allocated after January 6, 2004. However, paragraphs (a), (b), (c), (e), (i)(2) and (k) of this section may be applied by Agencies and taxpayers for housing credit dollar amounts allocated after December 31, 2000, and on or before January 6, 2004. Otherwise, subject to the applicable effective dates of

the corresponding statutory provisions, the rules that apply for housing credit dollar amounts allocated on or before January 6, 2004, are contained in this section in effect on and before January 6, 2004 (*see* 26 CFR part 1 revised as of April 1, 2003).

[T.D. 8563, 59 FR 50163, Oct. 3, 1994; 60 FR 3345, Jan. 17, 1995, as amended by T.D. 9110, 69 FR 504, Jan. 6, 2004; 69 FR 8331, Feb. 24, 2004]

§ 1.42–15 Available unit rule.

(a) *Definitions.* The following definitions apply to this section:

Applicable income limitation means the limitation applicable under section 42(g)(1) or, for deep rent skewed projects described in section 142(d)(4)(B), 40 percent of area median gross income.

Available unit rule means the rule in section 42(g)(2)(D)(ii).

Comparable unit means a residential unit in a low-income building that is comparably sized or smaller than an over-income unit or, for deep rent skewed projects described in section 142(d)(4)(B), any low-income unit. For purposes of determining whether a residential unit is comparably sized, a comparable unit must be measured by the same method used to determine qualified basis for the credit year in which the comparable unit became available.

Current resident means a person who is living in the low-income building.

Low-income unit is defined by section 42(i)(3)(A).

Nonqualified resident means a new occupant or occupants whose aggregate income exceeds the applicable income limitation.

Over-income unit means a low-income unit in which the aggregate income of the occupants of the unit increases above 140 percent of the applicable income limitation under section 42(g)(1), or above 170 percent of the applicable income limitation for deep rent skewed projects described in section 142(d)(4)(B).

Qualified resident means an occupant either whose aggregate income (combined with the income of all other occupants of the unit) does not exceed the applicable income limitation and who is otherwise a low-income resident under section 42, or who is a current resident.

(b) *General section 42(g)(2)(D)(i) rule.* Except as provided in paragraph (c) of this section, notwithstanding an increase in the income of the occupants of a low-income unit above the applicable income limitation, if the income of the occupants initially met the applicable income limitation, and the unit continues to be rent-restricted—

(1) The unit continues to be treated as a low-income unit; and

(2) The unit continues to be included in the numerator and the denominator of the ratio used to determine whether a project satisfies the applicable minimum set-aside requirement of section 42(g)(1).

(c) *Exception.* A unit ceases to be treated as a low-income unit if it becomes an over-income unit and a nonqualified resident occupies any comparable unit that is available or that subsequently becomes available in the same low-income building. In other words, the owner of a low-income building must rent to qualified residents all comparable units that are available or that subsequently become available in the same building to continue treating the over-income unit as a low-income unit. Once the percentage of low-income units in a building (excluding the over-income units) equals the percentage of low-income units on which the credit is based, failure to maintain the over-income units as low-income units has no immediate significance. The failure to maintain the over-income units as low-income units, however, may affect the decision of whether or not to rent a particular available unit at market rate at a later time. A unit is not available for purposes of the available unit rule when the unit is no longer available for rent due to contractual arrangements that are binding under local law (for example, a unit is not available if it is subject to a preliminary reservation that is binding on the owner under local law prior to the date a lease is signed or the unit is occupied).

(d) *Effect of current resident moving within building.* When a current resident moves to a different unit within the building, the newly occupied unit adopts the status of the vacated unit.

Thus, if a current resident, whose income exceeds the applicable income limitation, moves from an over-income unit to a vacant unit in the same building, the newly occupied unit is treated as an over-income unit. The vacated unit assumes the status the newly occupied unit had immediately before it was occupied by the current resident.

(e) *Available unit rule applies separately to each building in a project.* In a project containing more than one low-income building, the available unit rule applies separately to each building.

(f) *Result of noncompliance with available unit rule.* If any comparable unit that is available or that subsequently becomes available is rented to a nonqualified resident, all over-income units for which the available unit was a comparable unit within the same building lose their status as low-income units; thus, comparably sized or larger over-income units would lose their status as low-income units.

(g) *Relationship to tax-exempt bond provisions.* Financing arrangements that purport to be exempt-facility bonds under section 142 must meet the requirements of sections 103 and 141 through 150 for interest on the obligations to be excluded from gross income under section 103(a). This section is not intended as an interpretation under section 142.

(h) *Examples.* The following examples illustrate this section:

Example 1. This example illustrates noncompliance with the available unit rule in a low-income building containing three over-income units. On January 1, 1998, a qualified low-income housing project, consisting of one building containing ten identically sized residential units, received a housing credit dollar amount allocation from a state housing credit agency for five low-income units. By the close of 1998, the first year of the credit period, the project satisfied the minimum set-aside requirement of section 42(g)(1)(B). Units 1, 2, 3, 4, and 5 were occupied by individuals whose incomes did not exceed the income limitation applicable under section 42(g)(1) and were otherwise low-income residents under section 42. Units 6, 7, 8, and 9 were occupied by market-rate tenants. Unit 10 was vacant. To avoid recapture of credit, the project owner must maintain five of the units as low-income units. On November 1, 1999, the certificates of annual income state that annual incomes of the individuals in Units 1, 2, and 3 increased above 140 percent of the income limitation applicable under section 42(g)(1), causing those units to become over-income units. On November 30, 1999, Units 8 and 9 became vacant. On December 1, 1999, the project owner rented Units 8 and 9 to qualified residents who were not current residents at rates meeting the rent restriction requirements of section 42(g)(2). On December 31, 1999, the project owner rented Unit 10 to a market-rate tenant. Because Unit 10, an available comparable unit, was leased to a market-rate tenant, Units 1, 2, and 3 ceased to be treated as low-income units. On that date, Units 4, 5, 8, and 9 were the only remaining low-income units. Because the project owner did not maintain five of the residential units as low-income units, the qualified basis in the building is reduced, and credit must be recaptured. If the project owner had rented Unit 10 to a qualified resident who was not a current resident, eight of the units would be low-income units. At that time, Units 1, 2, and 3, the over-income units, could be rented to market-rate tenants because the building would still contain five low-income units.

Example 2. This example illustrates the provisions of paragraph (d) of this section. A low-income project consists of one six-floor building. The residential units in the building are identically sized. The building contains two over-income units on the sixth floor and two vacant units on the first floor. The project owner, desiring to maintain the over-income units as low-income units, wants to rent the available units to qualified residents. J, a resident of one of the over-income units, wishes to occupy a unit on the first floor. J's income has recently increased above the applicable income limitation. The project owner permits J to move into one of the units on the first floor. Despite J's income exceeding the applicable income limitation, J is a qualified resident under the available unit rule because J is a current resident of the building. The unit newly occupied by J becomes an over-income unit under the available unit rule. The unit vacated by J assumes the status the newly occupied unit had immediately before J occupied the unit. The over-income units in the building continue to be treated as low-income units.

(i) *Effective date.* This section applies to leases entered into or renewed on and after September 26, 1997.

[T.D. 8732, 62 FR 50505, Sept. 26, 1997]

§ 1.42–16 Eligible basis reduced by federal grants.

(a) *In general.* If, during any taxable year of the compliance period (described in section 42(i)(1)), a grant is made with respect to any building or the operation thereof and any portion of the grant is funded with federal funds (whether or not includible in gross income), the eligible basis of the building for the taxable year and all succeeding taxable years is reduced by the portion of the grant that is so funded.

(b) *Grants do not include certain rental assistance payments.* A federal rental assistance payment made to a building owner on behalf or in respect of a tenant is not a grant made with respect to a building or its operation if the payment is made pursuant to—

(1) Section 8 of the United States Housing Act of 1937 (42 U.S.C. 1437f)

(2) A qualifying program of rental assistance administered under section 9 of the United States Housing Act of 1937 (42 U.S.C. 1437g); or

(3) A program or method of rental assistance 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).

(c) *Qualifying rental assistance program.* For purposes of paragraph (b)(2) of this section, payments are made pursuant to a qualifying rental assistance program administered under section 9 of the United States Housing Act of 1937 to the extent that the payments—

(1) Are made to a building owner pursuant to a contract with a public housing authority with respect to units the owner has agreed to maintain as public housing units (PH-units) in the building;

(2) Are made with respect to units occupied by public housing tenants, provided that, for this purpose, units may be considered occupied during periods of short term vacancy (not to exceed 60 days); and

(3) Do not exceed the difference between the rents received from a building's PH-unit tenants and a pro rata portion of the building's actual operating costs that are reasonably allocable to the PH-units (based on square footage, number of bedrooms, or similar objective criteria), and provided that, for this purpose, operating costs do not include any development costs of a building (including developer's fees) or the principal or interest of any debt incurred with respect to any part of the building.

(d) *Effective date.* This section is effective September 26, 1997.

[T.D. 8731, 62 FR 50503, Sept. 26, 1997]

§ 1.42–17 Qualified allocation plan.

(a) *Requirements*—(1) *In general.* [Reserved]

(2) *Selection criteria.* [Reserved]

(3) *Agency evaluation.* Section 42(m)(2)(A) requires that the housing credit dollar amount allocated to a project is not to exceed the amount the Agency determines is necessary for the financial feasibility of the project and its viability as a qualified low-income housing project throughout the credit period. In making this determination, the Agency must consider—

(i) The sources and uses of funds and the total financing planned for the project. The taxpayer must certify to the Agency the full extent of all federal, state, and local subsidies that apply (or which the taxpayer expects to apply) to the project. The taxpayer must also certify to the Agency all other sources of funds and all development costs for the project. The taxpayer's certification should be sufficiently detailed to enable the Agency to ascertain the nature of the costs that will make up the total financing package, including subsidies and the anticipated syndication or placement proceeds to be raised. Development cost information, whether or not includible in eligible basis under section 42(d), that should be provided to the Agency includes, but is not limited to, site acquisition costs, construction contingency, general contractor's overhead and profit, architect's and engineer's fees, permit and survey fees, insurance premiums, real estate taxes during construction, title and recording fees, construction period interest, financing fees, organizational costs, rent-up and marketing costs, accounting and auditing costs, working capital and operating deficit reserves, syndication and legal fees, and developer fees;

(ii) Any proceeds or receipts expected to be generated by reason of tax benefits;

(iii) The percentage of the housing credit dollar amount used for project costs other than the costs of intermediaries. This requirement should not be applied so as to impede the development of projects in hard-to-develop areas under section 42(d)(5)(C); and

(iv) The reasonableness of the developmental and operational costs of the project.

(4) *Timing of Agency evaluation*—(i) *In general*. The financial determinations and certifications required under paragraph (a)(3) of this section must be made as of the following times—

(A) The time of the application for the housing credit dollar amount;

(B) The time of the allocation of the housing credit dollar amount; and

(C) The date the building is placed in service.

(ii) *Time limit for placed-in-service evaluation*. For purposes of paragraph (a)(4)(i)(C) of this section, the evaluation for when a building is placed in service must be made not later than the date the Agency issues the Form 8609, ''Low-Income Housing Credit Allocation Certification.'' The Agency must evaluate all sources and uses of funds under paragraph (a)(3)(i) of this section paid, incurred, or committed by the taxpayer for the project up until date the Agency issues the Form 8609.

(5) *Special rule for final determinations and certifications*. For the Agency's evaluation under paragraph (a)(4)(i)(C) of this section, the taxpayer must submit a schedule of project costs. Such schedule is to be prepared on the method of accounting used by the taxpayer for federal income tax purposes, and must detail the project's total costs as well as those costs that may qualify for inclusion in eligible basis under section 42(d). For projects with more than 10 units, the schedule of project costs must be accompanied by a Certified Public Accountant's audit report on the schedule (an Agency may require an audited schedule of project costs for projects with fewer than 11 units). The CPA's audit must be conducted in accordance with generally accepted auditing standards. The auditor's report must be unqualified.

(6) *Bond-financed projects*. A project qualifying under section 42(h)(4) is not entitled to any credit unless the governmental unit that issued the bonds (or on behalf of which the bonds were issued), or the Agency responsible for issuing the Form(s) 8609 to the project, makes determinations under rules similar to the rules in paragraphs (a)(3), (4), and (5) of this section.

(b) *Effective date*. This section is effective on January 1, 2001.

[T.D. 8859, 65 FR 2329, Jan. 14, 2000]

§ 1.42–18 Qualified contracts.

(a) *Extended low-income housing commitment*—(1) *In general*. No credit under section 42(a) is allowed by reason of section 42 with respect to any building for the taxable year unless an extended low-income housing commitment (commitment) (as defined in section 42(h)(6)(B)) is in effect as of the end of such taxable year. A commitment must be in effect for the extended use period (as defined in paragraph (a)(1)(i) of this section).

(i) *Extended use period*. The term *extended use period* means the period beginning on the first day in the compliance period (as defined in section 42(i)(1)) on which the building is part of a qualified low-income housing project (as defined in section 42(g)(1)) and ending on the later of—

(A) The date specified by the low-income housing credit agency (Agency) in the commitment; or

(B) The date that is 15 years after the close of the compliance period.

(ii) *Termination of extended use period*. The extended use period for any building will terminate—

(A) On the date the building is acquired by foreclosure (or instrument in lieu of foreclosure) unless the Commissioner determines that such acquisition is part of an arrangement with the taxpayer (''the owner'') a purpose of which is to terminate such period; or

(B) On the last day of the one-year period beginning on the date (after the 14th year of the compliance period) on which the owner submits a written request to the Agency to find a person to acquire the owner's interest in the low-income portion of the building if the Agency is unable to present during such period a qualified contract for the acquisition of the low-income portion of the building by any person who will continue to operate such portion as a qualified low-income building (as defined in section 42(c)(2)).

(iii) *Owner non-acceptance*. If the Agency provides a qualified contract within the one-year period and the owner rejects or fails to act upon the contract, the building remains subject to the existing commitment.

(iv) *Eviction, gross rent increase concerning existing low-income tenants not permitted*. Prior to the close of the three year period following the termination of a commitment, no owner shall be permitted to evict or terminate the tenancy (other than for good cause) of an existing tenant of any low-income unit, or increase the gross rent for such unit in a manner or amount not otherwise permitted by section 42.

(2) *Exception*. Paragraph (a)(1)(ii)(B) of this section shall not apply to the extent more stringent requirements are provided in the commitment or under State law.

(b) *Definitions*. For purposes of this section, the following terms are defined:

(1) As provided by section 42(h)(6)(G)(iii), *base calendar year* means the calendar year with or within which the first taxable year of the credit period ends.

(2) The *low-income portion* of a building is the portion of the building equal to the applicable fraction (as defined in section 42(c)(1)(B)) specified in the commitment for the building.

(3) The *fair market value of the non-low-income portion* of the building is determined at the time of the Agency's offer of sale of the building to the general public. The fair market value of the non-low-income portion also includes the fair market value of the land underlying the entire building (both the non-low-income portion and the low-income portion). This valuation must take into account the existing and continuing requirements contained in the commitment for the building. The fair market value of the non-low-income portion also includes the fair market value of items of personal property not included in eligible basis under section 42(d) that convey under the contract with the building.

(4) *Qualifying building costs include*—

(i) Costs that are included in eligible basis of a low-income housing building under section 42(d) and that are included in the adjusted basis of depreciable property that is subject to section 168 and that is residential rental property for purposes of section 142(d) and § 1.103–8(b);

(ii) Costs that are included in eligible basis of a low-income housing building under section 42(d) and that are included in the adjusted basis of depreciable property that is subject to section 168 and that is used in a common area or is provided as a comparable amenity to all residential rental units in the building; and

(iii) Costs of the type described in paragraph (b)(4)(i) and (ii) of this section incurred after the first year of the low-income housing building's credit period under section 42(f).

(5) The *qualified contract amount* is the sum of the fair market value of the non-low-income portion of the building (within the meaning of section 42(h)(6)(F) and paragraph (b)(3) of this section) and the price for the low-income portion of the building (within the meaning of section 42(h)(6)(F) and paragraph (b)(2) of this section) as calculated in paragraph (c)(2) of this section. If this sum is not a multiple of $1,000, then when the Agency offers the building for sale to the general public, the Agency may round up the offering price to the next highest multiple of $1,000.

(c) *Qualified contract purchase price formula*—(1) *In general*. For purposes of this section, *qualified contract* means a bona fide contract to acquire the building (within a reasonable period after the contract is entered into) for the qualified contract amount.

(i) *Initial determination*. The qualified contract amount is determined at the time of the Agency's offer of sale of the building to the general public.

(ii) *Mandatory adjustment by the buyer and owner*. The buyer and owner under a qualified contract must adjust the amount of the low-income portion of the qualified contract formula to reflect changes in the components of the qualified contract formula such as mortgage payments that reduce outstanding indebtedness between the time of the Agency's offer of sale to the general public and the building's actual sale closing date.

(iii) *Optional adjustment by the Agency and owner*. The Agency and owner may agree to adjust the fair market value of the non low-income portion of the building after the Agency's offer of sale of the building to the general public and before the close of the one-year period described in paragraph (a)(1)(ii)(B) of this section. If no agreement between the Agency and owner is reached, the fair market value of the non-low-income portion of the building determined at the time of the Agency's offer of sale of the building to the general public remains unchanged.

(2) *Low-income portion amount.* The low-income portion amount is an amount not less than the applicable fraction specified in the commitment, as defined in section 42(h)(6)(B)(i), multiplied by the total of—

(i) The outstanding indebtedness for the building (as defined in paragraph (c)(3) of this section); plus

(ii) The adjusted investor equity in the building for the calendar year (as defined in paragraph (c)(4) of this section); plus

(iii) Other capital contributions (as defined in paragraph (c)(5) of this section), not including any amounts described in paragraphs (c)(2)(i) and (ii) of this section; minus

(iv) Cash distributions from (or available for distribution from) the building (as defined in paragraph (c)(6) of this section).

(3) *Outstanding indebtedness.* For purposes of paragraph (c)(2)(i) of this section, *outstanding indebtedness* means the remaining stated principal balance (which is initially determined at the time of the Agency's offer of sale of the building to the general public) of any indebtedness secured by, or with respect to, the building that does not exceed the amount of qualifying building costs described in paragraph (b)(4) of this section. Thus, any refinancing indebtedness or additional mortgages in excess of such qualifying building costs are not outstanding indebtedness for purposes of section 42(h)(6)(F) and this section. Examples of outstanding indebtedness include certain mortgages and developer fee notes (excluding developer service costs not included in eligible basis). Outstanding indebtedness does not include debt used to finance nondepreciable land costs, syndication costs, legal and accounting costs, and operating deficit payments. Outstanding indebtedness includes only obligations that are indebtedness under general principles of Federal income tax law and that are actually paid to the lender upon the sale of the building or are assumed by the buyer as part of the sale of the building.

(4) *Adjusted investor equity*—(i) *Application of cost-of-living factor.* For purposes of paragraph (c)(2)(ii) of this section, the *adjusted investor equity* for any calendar year equals the unadjusted investor equity, as described in paragraph (c)(4)(ii) of this section, multiplied by the qualified-contract cost-of-living adjustment for that year, as defined in paragraph (c)(4)(iii) of this section.

(ii) *Unadjusted investor equity.* For purposes of this paragraph (c)(4), *unadjusted investor equity* means the aggregate amount of cash invested by owners for qualifying building costs described in paragraph (b)(4)(i) and (ii) of this section. Thus, equity paid for land, credit adjuster payments, Agency low-income housing credit application and allocation fees, operating deficit contributions, and legal, syndication, and accounting costs all are examples of cost payments that do not qualify as unadjusted investor equity. Unadjusted investor equity takes an amount into account only to the extent that, as of the beginning of the low-income building's credit period (as defined in section 42(f)(1)), there existed an obligation to invest the amount. Unadjusted investor equity does not include amounts included in the calculation of outstanding indebtedness as defined in paragraph (c)(3) of this section.

(iii) *Qualified-contract cost-of-living adjustment.* For purposes of this paragraph (c)(4), the *qualified-contract cost-of-living adjustment for a calendar year* is the number that is computed under the general rule in paragraph (c)(4)(iv) of this section or a number that may be provided by the Commissioner as described in paragraph (c)(4)(v) of this section.

(iv) *General rule.* Except as provided in paragraph (c)(4)(v) of this section, the *qualified-contract cost-of-living adjustment* is the quotient of—

(A) The sum of the 12 monthly Consumer Price Index (CPI) values whose average is the CPI for the calendar year that precedes the calendar year in which the Agency offers the building for sale to the general public (The term ''CPI for a calendar year'' has the meaning given to it by section 1(f)(4) for purposes of computing annual inflation adjustments to the rate brackets.); divided by

(B) The sum of the 12 monthly CPI values whose average is the CPI for the base calendar year (within the meaning of section 1(f)(4)), unless that sum has been increased under paragraph (c)(4)(iii)(D) of this section.

(v) *Provision by the Commissioner of the qualified-contract cost-of-living adjustment.* The Commissioner may publish in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter) a process pursuant to which the Internal Revenue Service will compute the qualified-contract cost-of-living adjustment for a calendar year and make available the results of that computation.

(vi) *Methodology.* The calculations in paragraph (c)(4)(iv) of this section are to be made in the following manner:

(A) The CPI data to be used for purposes of this paragraph (c)(4) are the not seasonally adjusted values of the CPI for all urban consumers. (The U.S. Department of Labor's Bureau of Labor Statistics (BLS) sometimes refers to these values as ''CPI–U.'') The BLS publishes the CPI data on-line (including a History Table that contains monthly CPI–U values for all years back to 1913). See *www.BLS.gov/data.*

(B) The quotient is to be carried out to 10 decimal places.

(C) The Agency may round adjusted investor equity to the nearest dollar.

(D) If the CPI for any calendar year (within the meaning of section 1(f)(4)) during the extended use period after the base calendar year exceeds by more than 5 percent the CPI for the preceding calendar year (within the meaning of section 1(f)(4)), then the sum described in paragraph (c)(4)(i)(B) is to be increased so that the excess is never taken into account under this paragraph (c)(4).

(vii) *Example.* The following example illustrates the calculations described in this paragraph (c)(4):

Example. (i) *Facts.* Owner contributed $20,000,000 in equity to a building in 1997, which was the first year of the credit period for the building. In 2011, Owner requested Agency to find a buyer to purchase the building, and Agency offered the building for sale to the general public during 2011. The CPI for 1997 (within the meaning of section 1(f)(4)) is the average of the Consumer Price Index as of the close of the 12-month period ending on August 31, 1997. The sum of the CPI values for the twelve months from September 1996 through August 1997 is 1913.9. The CPI for 2010 (within the meaning of section 1(f)(4)) is the average of the Consumer Price Index as of the close of the 12-month period ending August 31, 2010. The sum of the CPI values for the twelve months from September 2009 through August 2010 is 2605.959. At no time during this period (after the base calendar year) did the CPI for any calendar year exceed the CPI for the preceding calendar year by more than 5 percent.

(ii) *Determination of adjusted investor equity.* The qualified-contract cost-of-living adjustment is 1.3615962171 (the quotient of 2605.959, divided by 1913.9). Owner's adjusted investor equity, therefore, is $27,231,924, which is $20,000,000, multiplied by 1.3615962171, rounded to the nearest dollar.

(5) *Other capital contributions.* For purposes of paragraph (c)(2)(iii) of this section, other capital contributions to a low-income building are qualifying building costs described in paragraph (b)(4)(ii) of this section paid or incurred by the owner of the low-income building other than amounts included in the calculation of outstanding indebtedness or adjusted investor equity as defined in this section. For example, other capital contributions may include amounts incurred to replace a furnace after the first year of a low-income housing credit building's credit period under section 42(f), provided any loan used to finance the replacement of the furnace is not secured by the furnace or the building. Other capital contributions do not include expenditures for land costs, operating deficit payments, credit adjuster payments, and payments for legal, syndication, and accounting costs.

(6) *Cash distributions*—(i) *In general.* For purposes of paragraph (c)(2)(iv) of this section, the term *cash distributions from (or available for distribution from)* the building include—

(A) All distributions from the building to the owners or to persons whose relationship to the owner is described in section 267(b) or section 707(b)(1)), including distributions under section

301 (relating to distributions by a corporation), section 731 (relating to distributions by a partnership), or section 1368 (relating to distributions by an S corporation); and

(B) All cash and cash equivalents available for distribution at, or before, the time of sale, including, for example, reserve funds whether operating or replacement reserves, unless the reserve funds are legally required by mortgage restrictions, regulatory agreements, or third party contractual agreements to remain with the building following the sale.

(ii) *Excess proceeds.* For purposes of paragraph (c)(6)(i) of this section, proceeds from the refinancing of indebtedness or additional mortgages that are in excess of qualifying building costs are not considered cash available for distribution.

(iii) *Anti-abuse rule.* The Commissioner will interpret and apply the rules in this paragraph (c)(6) as necessary and appropriate to prevent manipulation of the qualified contract amount. For example, cash distributions include payments to owners or persons whose relation to owners is described in section 267(b) or section 707(b) for any operating expenses in excess of amounts reasonable under the circumstances.

(d) *Administrative discretion and responsibilities of the Agency*—(1) *In general.* An Agency may exercise administrative discretion in evaluating and acting upon an owner's request to find a buyer to acquire the building. An Agency may establish reasonable requirements for written requests and may determine whether failure to follow one or more applicable requirements automatically prevents a purported written request from beginning the one-year period described in section 42(h)(6)(I). If the one-year-period has already begun, the Agency may determine whether failure to follow one or more requirements suspends the running of that period. Examples of Agency administrative discretion include, but are not limited to, the following:

(i) Concluding that the owner's request lacks essential information and denying the request until such information is provided.

(ii) Refusing to consider an owner's representations without substantiating documentation verified with the Agency's records.

(iii) Determining how many, if any, subsequent requests to find a buyer may be submitted if the owner has previously submitted a request for a qualified contract and then rejected or failed to act upon a qualified contract presented by the Agency.

(iv) Assessing and charging the owner certain administrative fees for the performance of services in obtaining a qualified contract (for example, real estate appraiser costs).

(v) Requiring all appraisers involved in the qualified contract process to be State certified general appraisers that are acceptable to the Agency.

(vi) Specifying other conditions applicable to the qualified contract consistent with section 42 and this section.

(2) *Actual offer.* Upon receipt of a written request from the owner to find a person to acquire the building, the Agency must offer the building for sale to the general public, based on reasonable efforts, at the determined qualified contract amount in order for the qualified contract to satisfy the requirements of this section unless the Agency has already identified a willing buyer who submitted a qualified contract to purchase the project.

(3) *Debarment of certain appraisers.* Agencies shall not utilize any individual or organization as an appraiser if that individual or organization is currently on any list for active suspension or revocation for performing appraisals in any State or is listed on the Excluded Parties Lists System (EPLS) maintained by the General Services Administration for the United States Government found at *www.epls.gov.*

(e) *Effective date/applicability date.* These regulations are applicable to owner requests to housing credit agencies on or after May 3, 2012 to obtain a qualified contract for the acquisition of a low-income housing credit building.

[T.D. 9587, 77 FR 26178, May 3, 2012]

§ 1.42A–1 General tax credit for taxable years ending after December 31, 1975, and before January 1, 1979.

(a)(1) *Allowance of credit for taxable years ending after December 31, 1975, and beginning before January 1, 1977.* Subject to the special rules of paragraphs (b)(1), (c) and (d) and the limitation of paragraph (e)(1) of this section, an individual is allowed as a credit against the tax imposed by chapter 1 for the taxable year in the case of taxable years ending after December 31, 1975, and beginning before January 1, 1977, an amount equal to the greater of—

(i) 2 percent of so much of the individual's taxable income as does not exceed $9,000, or

(ii) $35 multiplied by the total number of deductions for personal exemptions to which the individual is entitled for the taxable year under section 151 (b) and (e) and the regulations thereunder (relating to allowance of deductions for personal exemptions with respect to the individual, the individual's spouse, and dependents).

For purposes of applying subdivision (ii) of this paragraph (a)(1), the total number of deductions for personal exemptions shall not include any additional exemptions to which the individual or his spouse may be entitled based upon age of 65 or more or blindness under section 151 (c) or (d) and the regulations thereunder.y

(2) *Allowance of credit for taxable years beginning after December 31, 1976, and ending before January 1, 1979.* Subject to the special rules of paragraphs (b)(2), (c) and (d) and the limitation of paragraph (e)(2) of this section, an individual is allowed as a credit against the tax imposed by section 1, or against the tax imposed in lieu of the tax imposed by section 1, for the taxable year in the case of taxable years beginning after December 31, 1976, and ending before January 1, 1979, an amount equal to the greater of—

(i) 2 percent of so much of the individual's taxable income for the taxable year, reduced by the zero bracket amount determined under section 63 (d), as does not exceed $9,000, or

(ii) $35 multiplied by the total number of deductions for personal exemptions to which the individual is entitled for the taxable year under section 151 and the regulations thereunder (relating to allowance of deductions for personal exemptions).

(b) *Married individuals filing separate returns*—(1) *For taxable years ending after December 31, 1975, and beginning before January 1, 1977.* In the case of taxable years ending after December 31, 1975, and beginning before January 1, 1977, a married individual who files a separate return for the taxable year is allowed as a credit for the taxable year an amount equal to either—

(i) 2 percent of so much of the individual's taxable income as does not exceed $4,500, or

(ii) $35 multiplied by the total number of deductions for personal exemptions to which the individual is entitled for the taxable year under section 151 (b) and (e) and the regulations thereunder, but only if both the individual and the individual's spouse elect to have the credit determined in the manner described in this subdivision (ii) for their corresponding taxable years. The elections shall be made by both married individuals separately calculating and claiming the credit in the manner and amount described in this subdivision (ii) on their separate returns for their corresponding taxable years. The rules of section 142 (a) and the regulations thereunder (relating to individuals not eligible for the standard deduction) in effect for taxable years beginning before January 1, 1977, apply to determine whether the taxable years of the individual and the individual's spouse correspond to each other. For purposes of applying this subdivision (ii), the total number of deductions for personal exemptions shall not include any additional exemptions to which the individual may be entitled based upon age of 65 or more or blindness under section 151 (c) or (d) and the regulations thereunder.

(2) *For taxable years beginning after December 31, 1976, and ending before January 1, 1979.* In the case of taxable years beginning after December 31, 1976, and ending before January 1, 1979, a married individual who files a separate return for the taxable year shall determine the amount of the credit for the taxable year under section 42(a)(2) and § 1.42A–1(a)(2)(ii).

(3) *Determination of marital status.* For purposes of this paragraph, the determination of marital status shall be made as provided by section 143 and the regulations thereunder (relating to the determination of marital status).

(c) *Return for short period on change of annual accounting period.* In computing the credit provided by section 42 and this section for a period of less than 12 months (hereinafter referred to as a ''short period''), where income is to be annualized under section 443(b)(1) in order to determine the tax—

(1) The credit allowed by paragraphs (a) (1)(i) and (2)(i) of this section shall be computed based upon the amount of the taxable income annualized under the rules of section 443(b)(1) and §1.443–1(b)(1), or

(2)(i) The credit allowed by paragraph (a)(1)(ii) of this section shall be computed based upon the total number of deductions for personal exemptions to which the individual is entitled for the short period under section 151 (b) and (e) and the regulations thereunder (relating to allowance of deductions for personal exemptions with respect to the individual, the individual's spouse, and dependents), and

(ii) The credit allowed by paragraph (a)(2)(ii) of this section shall be computed based upon the total number of deductions for personal exemptions to which the individual is entitled for the short period under section 151 and the regulations thereunder (relating to allowance of deductions for personal exemptions).

As so computed, the credit allowed by section 42 and this section shall be allowed against the tax computed on the basis of the annualized taxable income. See §1.443–1(b)(1)(vi).

(d) *Certain persons not eligible*—(1) *Estates and trusts.* The credit provided by section 42 and this section shall not be allowed in the case of any estate or trust. Thus, the credit shall not be allowed to an estate of an individual in bankruptcy or to an estate of a deceased individual. However, in the case of a deceased individual, the credit shall be allowed on the decedent's final return filed by his executor or other representative. Also, the credit provided by section 42 and this section shall be allowed in the case of a return filed by an estate of an infant, incompetent, or an individual under a disability.

(2) *Nonresident alien individuals.* The credit provided by section 42 and this section shall not be allowed in the case of any nonresident alien individual. As used in this subparagraph, the term ''nonresident alien individual'' has the meaning provided by §1.871–2. See, however, section 6013(g) for election to treat nonresident alien individual as resident of the United States. The credit shall be allowed to an alien individual who is a resident of the United States for part of the taxable year. See §1.871–2(b) for rules relating to the determination of residence of an alien individual. For purposes of paragraphs (a) (1)(i) and (2)(i) of this section, the credit allowed shall be computed by taking into account only that portion of the individual's taxable income which is attributable to the period of his residence in the United States. For purposes of paragraph (a)(1)(ii) of this section, the credit allowed shall be computed by taking into account only the total number of deductions for personal exemptions to which the individual is entitled under section 151 (b) and (e) for the period of his residence in the United States. For purposes of paragraph (a)(2)(ii) of this section, the credit allowed shall be computed by taking into account only the total number of deductions for personal exemptions to which the individual is entitled under section 151 for the period of his residence in the United States. See §1.871–13 for rules relating to changes of residence status during a taxable year.

(e) *Limitation*—(1) *For taxable years ending after December 31, 1975, and beginning before January 1, 1977.* For taxable years ending after December 31, 1975, and beginning before January 1, 1977, the credit allowed by section 42 and this section shall not exceed the amount of tax imposed by chapter 1 for the taxable year. In the case of an alien individual who is a resident of the United States for a part of the taxable year, the credit allowed by section 42 and this section shall not exceed the amount of tax imposed by chapter 1 for that portion of the taxable year during which the alien individual was a resident of the United States. See §1.871–13.

(2) *For taxable years beginning after December 31, 1976, and ending before January 1, 1979.* For taxable years beginning after December 31, 1976, and ending before January 1, 1979, the credit allowed by section 42 and this section shall not exceed the amount of tax imposed by section 1, or the amount of tax imposed in lieu of the tax imposed by section 1, for the taxable year. In the case of an alien individual who is a resident of the United States for a part of the taxable year, the credit allowed by section 42 and this section shall not exceed the amount of tax imposed by section 1, or the amount of tax imposed in lieu of the tax imposed by section 1, for that portion of the taxable year during which the alien individual was a resident of the United States. See §1.871–13.

(f) *Application with other credits.* In determining the credits allowed under—

(1) Section 33 (relating to foreign tax credit),

(2) Section 37 (relating to credit for the elderly),

(3) Section 38 (relating to investment in certain depreciable property),

(4) Section 40 (relating to expenses of work incentive programs), and

(5) Section 41 (relating to contributions to candidates for public office),

the tax imposed for the taxable year shall first be reduced (before any other reduction) by the credit allowed by section 42 and this section for the taxable year.

(g) *Income tax tables to reflect credit.* The tables prescribed under section 3 shall reflect the credit allowed by section 42 and this section.

(h) *Effective dates.* The credit allowed by section 42 and this section applies only for taxable years ending after December 31, 1975, and before January 1, 1979.

[T.D. 7547, 43 FR 19653, May 8, 1978]

§ 1.43–0 Table of contents.

This section lists the captions contained in §§1.43–0 through 1.43–7.

[T.D. 8448, 57 FR 54923, Nov. 23, 1992]

§ 1.43–1 The enhanced oil recovery credit—general rules.

(a) *Claiming the credit*—(1) *In general.* The enhanced oil recovery credit (the "credit") is a component of the section 38 general business credit. A taxpayer that owns an operating mineral interest (as defined in § 1.614–2(b)) in a property may claim the credit for qualified enhanced oil recovery costs (as described in § 1.43–4) paid or incurred by the taxpayer in connection with a qualified enhanced oil recovery project (as described in § 1.43–2) undertaken with respect to the property. A taxpayer that does not own an operating mineral interest in a property may not claim the credit. To the extent a credit included in the current year business credit under section 38(b) is unused under section 38, the credit is carried back or forward under the section 39 business credit carryback and carryforward rules.

(2) *Examples.* The following examples illustrate the principles of this paragraph (a).

Example 1. Credit for operating mineral interest owner. In 1992, A, the owner of an operating mineral interest in a property, begins a qualified enhanced oil recovery project using cyclic steam. B, who owns no interest in the property, purchases and places in service a steam generator. B sells A steam, which A uses as a tertiary injectant described in section 193. Because A owns an operating mineral interest in the property with respect to which the project is undertaken, A may claim a credit for the cost of the steam. Although B owns the steam generator used to produce steam for the project, B may not claim a credit for B's costs because B does not own an operating mineral interest in the property.

Example 2. Credit for operating mineral interest owner. C and D are partners in CD, a partnership that owns an operating mineral interest in a property. In 1992, CD begins a qualified enhanced oil recovery project using cyclic steam. D purchases a steam generator and sells steam to CD. Because CD owns an operating mineral interest in the property with respect to which the project is undertaken, CD may claim a credit for the cost of the steam. Although D owns the steam generator used to produce steam for the project, D may not claim a credit for the costs of the steam generator because D paid these costs in a capacity other than that of an operating mineral interest owner.

(b) *Amount of the credit.* A taxpayer's credit is an amount equal to 15 percent of the taxpayer's qualified enhanced oil recovery costs for the taxable year, reduced by the phase-out amount, if any, determined under paragraph (c) of this section.

(c) *Phase-out of the credit as crude oil prices increase*—(1) *In general.* The amount of the credit (determined without regard to this paragraph (c)) for any taxable year is reduced by an amount which bears the same ratio to the amount of the credit (determined without regard to this paragraph (c)) as—

(i) The amount by which the reference price determined under section 29(d)(2)(C) for the calendar year immediately preceding the calendar year in which the taxable year begins exceeds

$28 (as adjusted under paragraph (c)(2) of this section); bears to

(ii) $6.

(2) *Inflation adjustment*—(i) *In general.* For any taxable year beginning in a calendar year after 1991, an amount equal to $28 multiplied by the inflation adjustment factor is substituted for the $28 amount under paragraph (c)(1)(i) of this section.

(ii) *Inflation adjustment factor.* For purposes of this paragraph (c), the inflation adjustment factor for any calendar year is a fraction, the numerator of which is the GNP implicit price deflator for the preceding calendar year and the denominator of which is the GNP implicit price deflator for 1990. The ''GNP implicit price deflator'' is the first revision of the implicit price deflator for the gross national product as computed and published by the Secretary of Commerce. As early as practicable, the inflation adjustment factor for each calendar year will be published by the Internal Revenue Service in the Internal Revenue Bulletin.

(3) *Examples.* The following examples illustrate the principles of this paragraph (c).

Example 1. Reference price exceeds $28. In 1992, E, the owner of an operating mineral interest in a property, incurs $100 of qualified enhanced oil recovery costs. The reference price for 1991 determined under section 29(d)(2)(C) is $30 and the inflation adjustment factor for 1992 is 1. E's credit for 1992 determined without regard to the phase-out for crude oil price increases is $15 ($100 × 15%). In determining E's credit, the credit is reduced by $5 ($15 × ($30 − ($28 × 1))/6). Accordingly, E's credit for 1992 is $10 ($15 − $5).

Example 2. Inflation adjustment. In 1993, F, the owner of an operating mineral interest in a property, incurs $100 of qualified enhanced oil recovery costs. The 1992 reference price is $34, and the 1993 inflation adjustment factor is 1.10. F's credit for 1993 determined without regard to the phase-out for crude oil price increases is $15 ($100 × 15%). In determining F's credit, $30.80 (1.10 × $28) is substituted for $28, and the credit is reduced by $8 ($15 × ($34 − $30.80)/6). Accordingly, F's credit for 1993 is $7 ($15 − $8).

(d) *Reduction of associated deductions*—(1) *In general.* Any deduction allowable under chapter 1 for an expenditure taken into account in computing the amount of the credit determined under paragraph (b) of this section is reduced by the amount of the credit attributable to the expenditure.

(2) *Certain deductions by an integrated oil company.* For purposes of determining the intangible drilling and development costs that an integrated oil company must capitalize under section 291(b), the amount allowable as a deduction under section 263(c) is the deduction allowable after paragraph (d)(1) of this section is applied. See §1.43–4(b)(2) (extent to which integrated oil company intangible drilling and development costs are qualified enhanced oil recovery costs).

(e) *Basis adjustment.* For purposes of subtitle A, the increase in the basis of property which would (but for this paragraph (e)) result from an expenditure with respect to the property is reduced by the amount of the credit determined under paragraph (b) of this section attributable to the expenditure.

(f) *Passthrough entity basis adjustment*—(1) *Partners' interests in a partnership.* To the extent a partnership expenditure is not deductible under paragraph (d)(1) of this section or does not increase the basis of property under paragraph (e) of this section, the expenditure is treated as an expenditure described in section 705(a)(2)(B) (concerning decreases to basis of partnership interests). Thus, the adjusted bases of the partners' interests in the partnership are decreased (but not below zero).

(2) *Shareholders' stock in an S corporation.* To the extent an S corporation expenditure is not deductible under paragraph (d)(1) of this section or does not increase the basis of property under paragraph (e) of this section, the expenditure is treated as an expenditure described in section 1367(a)(2)(D) (concerning decreases to basis of S corporation stock). Thus, the bases of the shareholders' S corporation stock are decreased (but not below zero).

(g) *Examples.* The following examples illustrate the principles of paragraphs (d) through (f) of this section.

Example 1. Deductions reduced for credit amount. In 1992, G, the owner of an operating mineral interest in a property, incurs $100 of intangible drilling and development costs in connection with a qualified enhanced oil recovery project undertaken with respect to the property. G elects under section 263(c) to deduct these intangible drilling and development costs. The amount of the credit determined under paragraph (b) of this section attributable to the $100 of intangible drilling and development costs is $15 ($100 × 15%). Therefore, G's otherwise allowable deduction of $100 for the intangible drilling and development costs is reduced by $15. Accordingly, in 1992, G may deduct under section 263(c) only $85 ($100 − $15) for these costs.

Example 2. Integrated oil company deduction reduced. The facts are the same as in *Example 1,* except that G is an integrated oil company. As in *Example 1,* the amount of the credit determined under paragraph (b) of this section attributable to the $100 of intangible drilling and development costs is $15, and G's allowable deduction under section 263(c) is $85. Because G is an integrated oil company, G must capitalize 25.50 ($85 × 30%) under section 291(b). Therefore, in 1992, G may deduct under section 263(c) only $59.50 ($85 − $25.50) for these intangible drilling and development costs.

Example 3. Basis of property reduced. In 1992, H, the owner of an operating mineral interest in a property, pays $100 to purchase tangible property that is an integral part of a qualified enhanced oil recovery project undertaken with respect to the property. The amount of the credit determined under paragraph (b) of this section attributable to the $100 is $15 ($100 × 15%). Therefore, for purposes of subtitle A, H's basis in the tangible property is $85 ($100 − $15).

Example 4. Basis of interest in passthrough entity reduced. In 1992, I is a $50% partner in IJ, a partnership that owns an operating mineral interest in a property. IJ pays $200 to purchase tangible property that is an integral part of a qualified enhanced oil recovery project undertaken with respect to the property. The amount of the credit determined under paragraph (b) of this section attributable to the $200 is $30 ($200 × 15%). Therefore, for purposes of subtitle A, IJ's basis in the tangible property is $170 ($200 − $30). Under paragraph (f) of this section, the amount of the purchase price that does not increase the basis of the property ($30) is treated as an expenditure described in section 705(a)(2)(B). Therefore, I's basis in the partnership interest is reduced by $15 (I's allocable share of the section 705(a)(2)(B) expenditure ($30 × 50%)).

[T.D. 8448, 57 FR 54923, Nov. 23, 1992; 58 FR 7987, Feb. 11, 1993]

§ 1.43–2 Qualified enhanced oil recovery project.

(a) *Qualified enhanced oil recovery project.* A ''qualified enhanced oil recovery project'' is any project that meets all of the following requirements—

(1) The project involves the application (in accordance with sound engineering principles) of one or more qualified tertiary recovery methods (as described in paragraph (e) of this section) that is reasonably expected to result in more than an insignificant increase in the amount of crude oil that ultimately will be recovered;

(2) The project is located within the United States (within the meaning of section 638(1));

(3) The first injection of liquids, gases, or other matter for the project (as described in paragraph (c) of this section) occurs after December 31, 1990; and

(4) The project is certified under § 1.43–3.

(b) *More than insignificant increase.* For purposes of paragraph (a)(1) of this section, all the facts and circumstances determine whether the application of a tertiary recovery method can reasonably be expected to result in more than an insignificant increase in the amount of crude oil that ultimately will be recovered. Certain information submitted as part of a project certification is relevant to this determination. See § 1.43–3(a)(3)(i)(D). In no event is the application of a recovery method that merely accelerates the recovery of crude oil considered an application of one or more qualified tertiary recovery methods that can reasonably be expected to result in more than an insignificant increase in the amount of crude oil that ultimately will be recovered.

(c) *First injection of liquids, gases, or other matter*—(1) *In general.* The ''first injection of liquids, gases, or other matter'' generally occurs on the date a tertiary injectant is first injected into the reservoir. The ''first injection of liquids, gases, or other matter'' does not include—

(i) The injection into the reservoir of any liquids, gases, or other matter for the purpose of pretreating or preflushing the reservoir to enhance the efficiency of the tertiary recovery method; or

(ii) Test or experimental injections.

(2) *Example*. The following example illustrates the principles of this paragraph (c).

Example. Injections to pretreat the reservoir. In 1989, A, the owner of an operating mineral interest in a property, began injecting water into the reservoir for the purpose of elevating reservoir pressure to obtain miscibility pressure to prepare for the injection of miscible gas in connection with an enhanced oil recovery project. In 1992, A obtains miscibility pressure in the reservoir and begins injecting miscible gas into the reservoir. The injection of miscible gas, rather than the injection of water, is the first injection of liquids, gases, or other matter into the reservoir for purposes of determining whether the first injection of liquids, gases, or other matter occurs after December 31, 1990.

(d) *Significant expansion exception*—(1) *In general*. If a project for which the first injection of liquids, gases, or other matter (within the meaning of paragraph (c)(1) of this section) occurred before January 1, 1991, is significantly expanded after December 31, 1990, the expansion is treated as a separate project for which the first injection of liquids, gases, or other matter occurs after December 31, 1990.

(2) *Substantially unaffected reservoir volume*. A project is considered significantly expanded if the injection of liquids, gases, or other matter after December 31, 1990, is reasonably expected to result in more than an insignificant increase in the amount of crude oil that ultimately will be recovered from reservoir volume that was substantially unaffected by the injection of liquids, gases, or other matter before January 1, 1991.

(3) *Terminated projects*. Except as otherwise provided in this paragraph (d)(3), a project is considered significantly expanded if each qualified tertiary recovery method implemented in the project prior to January 1, 1991, terminated more than 36 months before implementing an enhanced oil recovery project that commences after December 31, 1990. Notwithstanding the provisions of the preceding sentence, if a project implemented prior to January 1, 1991, is terminated for less than 36 months before implementing an enhanced oil recovery project that commences after December 31, 1990, a taxpayer may request permission to treat the project that commences after December 31, 1990, as a significant expansion. Permission will not be granted if the Internal Revenue Service determines that a project was terminated to make an otherwise nonqualifying project eligible for the credit. For purposes of section 43, a qualified tertiary recovery method terminates at the point in time when the method no longer results in more than an insignificant increase in the amount of crude oil that ultimately will be recovered. All the facts and circumstances determine whether a tertiary recovery method has terminated. Among the factors considered is the project plan, the unit plan of development, or other similar plan. A tertiary recovery method is not necessarily terminated merely because the injection of the tertiary injectant has ceased. For purposes of this paragraph (d)(1), a project is implemented when costs that will be taken into account in determining the credit with respect to the project are paid or incurred.

(4) *Change in tertiary recovery method*. If the application of a tertiary recovery method or methods with respect to an enhanced oil recovery project for which the first injection of liquids, gases, or other matter occurred before January 1, 1991, has not been terminated for more than 36 months, a taxpayer may request a private letter ruling from the Internal Revenue Service whether the application of a different tertiary recovery method or methods after December 31, 1990, that does not affect reservoir volume substantially unaffected by the previous tertiary recovery method or methods, is treated as a significant expansion. All the facts and circumstances determine whether a change in tertiary recovery method is treated as a significant expansion. Among the factors considered are whether the change in tertiary recovery method is in accordance with sound engineering principles and whether the change in method will result in more than an insignificant increase in the amount of crude oil that would be recovered using the previous method. A more intensive application of a tertiary recovery method after December 31, 1990, is not treated as a significant expansion.

(5) *Examples.* The following examples illustrate the principles of this paragraph (d).

Example 1. Substantially unaffected reservoir volume. In January 1988, B, the owner of an operating mineral interest in a property, began injecting steam into the reservoir in connection with a cyclic steam enhanced oil recovery project. The project affected only a portion of the reservoir volume. In 1992, B begins cyclic steam injections with respect to reservoir volume that was substantially unaffected by the previous cyclic steam project. Because the injection of steam into the reservoir in 1992 affects reservoir volume that was substantially unaffected by the previous cyclic steam injection, the cyclic steam injection in 1992 is treated as a separate project for which the first injection of liquids, gases, or other matter occurs after December 31, 1990.

Example 2. Tertiary recovery method terminated more than 36 months. In 1982, C, the owner of an operating mineral interest in a property, implemented a tertiary recovery project using cyclic steam injection as a method for the recovery of crude oil. The project was certified as a tertiary recovery project for purposes of the windfall profit tax. In May 1988, the application of the cyclic steam tertiary recovery method terminated. In July 1992, C begins drilling injection wells as part of a project to apply the steam drive tertiary recovery method with respect to the same project area affected by the cyclic steam method. C begins steam injections in September 1992. Because C commences an enhanced oil recovery project more than 36 months after the previous tertiary recovery method was terminated, the project is treated as a separate project for which the first injection of liquids, gases, or other matter occurs after December 31, 1990.

Example 3. Change in tertiary recovery method affecting substantially unaffected reservoir volume. In 1984, D, the owner of an operating mineral interest in a property, implemented a tertiary recovery project using cyclic steam as a method for the recovery of crude oil. The project was certified as a tertiary recovery project for purposes of the windfall profit tax. D continued the cyclic steam injection until 1992, when the tertiary recovery method was changed from cyclic steam injection to steam drive. The steam drive affects reservoir volume that was substantially unaffected by the cyclic steam injection. Because the steam drive affects reservoir volume that was substantially unaffected by the cyclic steam injection, the steam drive is treated as a separate project for which the first injection of liquids, gases, or other matter occurs after December 31, 1990.

Example 4. Change in tertiary recovery method not affecting substantially unaffected reservoir volume. In 1988, E, the owner of an operating mineral interest in a property, undertook an immiscible nitrogen enhanced oil recovery project that resulted in more than an insignificant increase in the ultimate recovery of crude oil from the property. E continued the immiscible nitrogen project until 1992, when the project was converted from immiscible nitrogen displacement to miscible nitrogen displacement by increasing the injection of nitrogen to increase reservoir pressure. The miscible nitrogen displacement affects the same reservoir volume that was affected by the immiscible nitrogen displacement. Because the miscible nitrogen displacement does not affect reservoir volume that was substantially unaffected by the immiscible nitrogen displacement nor was the immiscible nitrogen displacement project terminated for more than 36 months before the miscible nitrogen displacement project was implemented, E must obtain a ruling whether the change from immiscible nitrogen displacement to miscible nitrogen displacement is treated as a separate project for which the first injection of liquids, gases, or other matter occurs after December 31, 1990. If E does not receive a ruling, the miscible nitrogen displacement project is not a qualified project.

Example 5. More intensive application of a tertiary recovery method. In 1989, F, the owner of an operating mineral interest in a property, undertook an immiscible carbon dioxide displacement enhanced oil recovery project. F began injecting carbon dioxide into the reservoir under immiscible conditions. The injection of carbon dioxide under immiscible conditions resulted in more than an insignificant increase in the ultimate recovery of crude oil from the property. F continues to inject the same amount of carbon dioxide into the reservoir until 1992, when new engineering studies indicate that an increase in the amount of carbon dioxide injected is reasonably expected to result in a more than insignificant increase in the amount of crude oil that would be recovered from the property as a result of the previous injection of carbon dioxide. The increase in the amount of carbon dioxide injected affects the same reservoir volume that was affected by the previous injection of carbon dioxide. Because the additional carbon dioxide injected in 1992 does not affect reservoir volume that was substantially unaffected by the previous injection of carbon dioxide and the previous immiscible carbon dioxide displacement method was not terminated for more than 36 months before additional carbon dioxide was injected, the increase in the amount of carbon dioxide injected into the reservoir is not a significant expansion. Therefore, it is not a separate project for which the first injection of liquids, gases, or other matter occurs after December 31, 1990.

(e) *Qualified tertiary recovery methods*—(1) *In general.* For purposes of paragraph (a)(1) of this section, a "qualified tertiary recovery method" is any one or any combination of the tertiary recovery methods described in paragraph (e)(2) of this section. To account for advances in enhanced oil recovery technology, the Internal Revenue Service may by revenue ruling prescribe that a method not described in paragraph (e)(2) of this section is a "qualified tertiary recovery method." In addition, a taxpayer may request a private letter ruling that a method not described in paragraph (e)(2) of this section or in a revenue ruling is a qualified tertiary recovery method. Generally, the methods identified in revenue rulings or private letter rulings will be limited to those methods that involve the displacement of oil from the reservoir rock by means of modifying the properties of the fluids in the reservoir or providing the energy and drive mechanism to force the oil to flow to a production well. The recovery methods described in paragraph (e)(3) of this section are not "qualified tertiary recovery methods."

(2) *Tertiary recovery methods that qualify*—(i) *Thermal recovery methods*—(A) *Steam drive injection.* The continuous injection of steam into one set of wells (injection wells) or other injection source to effect oil displacement toward and production from a second set of wells (production wells);

(B) *Cyclic steam injection*—The alternating injection of steam and production of oil with condensed steam from the same well or wells; and

(C) *In situ combustion.* The combustion of oil or fuel in the reservoir sustained by injection of air, oxygen-enriched air, oxygen, or supplemental fuel supplied from the surface to displace unburned oil toward producing wells. This process may include the concurrent, alternating, or subsequent injection of water.

(ii) *Gas Flood recovery methods*—(A) *Miscible fluid displacement.* The injection of gas (e.g., natural gas, enriched natural gas, a liquified petroleum slug driven by natural gas, carbon dioxide, nitrogen, or flue gas) or alcohol into the reservoir at pressure levels such that the gas or alcohol and reservoir oil are miscible;

(B) *Carbon dioxide augmented waterflooding.* The injection of carbonated water, or water and carbon dioxide, to increase waterflood efficiency;

(C) *Immiscible carbon dioxide displacement.* The injection of carbon dioxide into an oil reservoir to effect oil displacement under conditions in which miscibility with reservoir oil is not obtained. This process may include the concurrent, alternating, or subsequent injection of water; and

(D) *Immiscible nonhydrocarbon gas displacement.* The injection of nonhydrocarbon gas (e.g., nitrogen) into an oil reservoir, under conditions in which miscibility with reservoir oil is not obtained, to obtain a chemical or physical reaction (other than pressure) between the oil and the injected gas or between the oil and other reservoir fluids. This process may include the concurrent, alternating, or subsequent injection of water.

(iii) *Chemical flood recovery methods*—(A) *Microemulsion flooding.* The injection of a surfactant system (e.g., a surfactant, hydrocarbon, cosurfactant, electrolyte, and water) to enhance the displacement of oil toward producing wells; and

(B) *Caustic flooding*—The injection of water that has been made chemically basic by the addition of alkali metal hydroxides, silicates, or other chemicals.

(iv) *Mobility control recovery method—Polymer augmented waterflooding.* The injection of polymeric additives with water to improve the areal and vertical sweep efficiency of the reservoir by increasing the viscosity and decreasing the mobility of the water injected. Polymer augmented waterflooding does not include the injection of polymers for the purpose of modifying the injection profile of the wellbore or the relative permeability of various layers of the reservoir, rather than modifying the water-oil mobility ratio.

(3) *Recovery methods that do not qualify.* The term "qualified tertiary recovery method" does not include—

(i) Waterflooding—The injection of water into an oil reservoir to displace oil from the reservoir rock and into the bore of the producing well;

(ii) Cyclic gas injection—The increase or maintenance of pressure by injection of hydrocarbon gas into the reservoir from which it was originally produced;

(iii) Horizontal drilling—The drilling of horizontal, rather than vertical, wells to penetrate hydrocarbon bearing formations;

(iv) Gravity drainage—The production of oil by gravity flow from drainholes that are drilled from a shaft or tunnel dug within or below the oil bearing zones; and

(v) Other methods—Any recovery method not specifically designated as a qualified tertiary recovery method in either paragraph (e)(2) of this section or in a revenue ruling or private letter ruling described in paragraph (e)(1) of this section.

(4) *Examples.* The following examples illustrate the principles of this paragraph (e).

Example 1. Polymer augmented waterflooding. In 1992 G, the owner of an operating mineral interest in a property, begins a waterflood project with respect to the property. To reduce the relative permeability in certain areas of the reservoir and minimize water coning, G injects polymers to plug thief zones and improve the areal and vertical sweep efficiency of the reservoir. The injection of polymers into the reservoir does not modify the water-oil mobility ratio. Accordingly, the injection of polymers into the reservoir in connection with the waterflood project does not constitute polymer augmented waterflooding and the project is not a qualified enhanced oil recovery project.

Example 2. Polymer augmented waterflooding. In 1993 H, the owner of an operating mineral interest in a property, begins a caustic flooding project with respect to the property. Engineering studies indicate that the relative permeability of various layers of the reservoir may result in the loss of the injectant to thief zones, thereby reducing the areal and vertical sweep efficiency of the reservoir. As part of the caustic flooding project, H injects polymers to plug the thief zones and improve the areal and vertical sweep efficiency of the reservoir. Because the polymers are injected into the reservoir to improve the effectiveness of the caustic flooding project, the project is a qualified enhanced oil recovery project.

[T.D. 8448, 57 FR 54925, Nov. 23, 1992; 58 FR 6678, Feb. 1, 1993]

§ 1.43–3 Certification

(a) *Petroleum engineer's certification of a project*—(1) *In general.* A petroleum engineer must certify, under penalties of perjury, that an enhanced oil recovery project meets the requirements of section 43(c)(2)(A). A petroleum engineer's certification must be submitted for each project. The petroleum engineer certifying a project must be duly registered or certified in any State.

(2) *Timing of certification.* The operator of an enhanced oil recovery project or any other operating mineral interest owner designated by the operator (''designated owner'') must submit a petroleum engineer's certification to the Internal Revenue Service Center, Austin, Texas, or such other place as may be designated by revenue procedure or other published guidance, not later than the last date prescribed by law (including extensions) for filing the operator's or designated owner's federal income tax return for the first taxable year for which the enhanced oil recovery credit (the ''credit'') is allowable. The operator may designate any other operating mineral interest owner (the ''designated owner'') to file the petroleum engineer's certification.

(3) *Content of certification*—(i) *In general.* A petroleum engineer's certification must contain the following information—

(A) The name and taxpayer identification number of the operator or the designated owner submitting the certification;

(B) A statement identifying the project, including its geographic location;

(C) A statement that the project involves a tertiary recovery method (as defined in section 43(c)(2)(A)(i)) and a description of the process used, including—

(*1*) A description of the implementation and operation of the project sufficient to establish that it is implemented and operated in accordance with sound engineering practices;

(*2*) If the project involves the application of a tertiary recovery method approved in a private letter ruling described in paragraph (e)(1) of § 1.43–2, a copy of the private letter ruling, and

(*3*) The date on which the first injection of liquids, gases, or other matter occurred or is expected to occur.

(D) A statement that the application of a qualified tertiary recovery method or methods is expected to result in more than an insignificant increase in the amount of crude oil that ultimately will be recovered, including—

(*1*) Data on crude oil reserve estimates covering the project area with and without the enhanced oil recovery process,

(*2*) Production history prior to implementation of the project and estimates of production after implementation of the project, and

(*3*) An adequate delineation of the reservoir, or portion of the reservoir, from which the ultimate recovery of crude oil is expected to be increased as a result of the implementation and operation of the project; and

(E) A statement that the petroleum engineer believes that the project is a qualified enhanced oil recovery project within the meaning of section 43(c)(2)(A).

(ii) *Additional information for significantly expanded projects.* The petroleum engineer's certification for a project that is significantly expanded must in addition contain—

(A) If the expansion affects reservoir volume that was substantially unaffected by a previously implemented project, an adequate delineation of the reservoir volume affected by the previously implemented project;

(B) If the expansion involves the implementation of an enhanced oil recovery project more than 36 months after the termination of a qualified tertiary recovery method that was applied before January 1, 1991, the date on which the previous tertiary recovery method terminated and an explanation of the data or assumptions relied upon to determine the termination date;

(C) If the expansion involves the implementation of an enhanced oil recovery project less than 36 months after the termination of a qualified tertiary recovery method that was applied before January 1, 1991, a copy of a private letter ruling from the Internal Revenue Service that the project implemented after December 31, 1990 is treated as a significant expansion; or

(D) If the expansion involves the application after December 31, 1990, of a tertiary recovery method or methods that do not affect reservoir volume that was substantially unaffected by the application of a different tertiary recovery method or methods before January 1, 1991, a copy of a private letter ruling from the Internal Revenue Service that the change in tertiary recovery method is treated as a significant expansion.

(b) *Operator's continued certification of a project*—(1) *In general.* For each taxable year following the taxable year for which the petroleum engineer's certification is submitted, the operator or designated owner must certify, under penalties of perjury, that an enhanced oil recovery project continues to be implemented substantially in accordance with the petroleum engineer's certification submitted for the project. An operator's certification must be submitted for each project.

(2) *Timing of certification.* The operator or designated owner of an enhanced oil recovery project must submit an operator's certification to the Internal Revenue Service Center, Austin, Texas, or such other place as may be designated by revenue procedure or other published guidance, not later than the last date prescribed by law (including extensions) for filing the operator's or designated owner's federal income tax return for any taxable year after the taxable year for which the petroleum engineer's certification is filed.

(3) *Content of certification.* An operator's certification must contain the following information—

(i) The name and taxpayer identification number of the operator or the designated owner submitting the certification;

(ii) A statement identifying the project including its geographic location and the date on which the petroleum engineer's certification was filed;

(iii) A statement that the project continues to be implemented substantially in accordance with the petroleum engineer's certification (as described in paragraph (a) of this section) submitted for the project; and

(iv) A description of any significant change or anticipated change in the information submitted under paragraph (a)(3) of this section, including a change in the date on which the first injection of liquids, gases, or other matter occurred or is expected to occur.

(c) *Notice of project termination*—(1) *In general*. If the application of a tertiary recovery method is terminated, the operator or designated owner must submit a notice of project termination to the Internal Revenue Service.

(2) *Timing of notice*. The operator or designated owner of an enhanced oil recovery project must submit the notice of project termination to the Internal Revenue Service Center, Austin, Texas, or such other place as may be designated by revenue procedure or other published guidance, not later than the last date prescribed by law (including extensions) for filing the operator's or designated owner's federal income tax return for the taxable year in which the project terminates.

(3) *Content of notice*. A notice of project termination must contain the following information—

(i) The name and taxpayer identification number of the operator or the designated owner submitting the notice;

(ii) A statement identifying the project including its geographic location and the date on which the petroleum engineer's certification was filed; and

(iii) The date on which the application of the tertiary recovery method was terminated.

(d) *Failure to submit certification*. If a petroleum engineer's certification (as described in paragraph (a) of this section) or an operator's certification (as described in paragraph (b) of this section) is not submitted in the time or manner prescribed by this section, the credit will be allowed only after the appropriate certifications are submitted.

[T.D. 8384, 56 FR 67177, Dec. 30, 1991; 57 FR 6074, Feb. 20, 1992; 57 FR 6353, Feb. 24, 1992. Redesignated and amended by T.D. 8448, 57 FR 54927, Nov. 23, 1992]

§ 1.43–4 Qualified enhanced oil recovery costs.

(a) *Qualifying costs*—(1) *In general*. Except as provided in paragraph (e) of this section, amounts paid or incurred in any taxable year beginning after December 31, 1990, that are qualified tertiary injectant expenses (as described in paragraph (b)(1) of this section), intangible drilling and development costs (as described in paragraph (b)(2) of this section), and tangible property costs (as described in paragraph (b)(3) of this section) are ''qualified enhanced oil recovery costs'' if the amounts are paid or incurred with respect to an asset which is used for the primary purpose (as described in paragraph (c) of this section) of implementing an enhanced oil recovery project. Any amount paid or incurred in any taxable year beginning before January 1, 1991, in connection with an enhanced oil recovery project is not a qualified enhanced oil recovery cost.

(2) *Costs paid or incurred for an asset which is used to implement more than one qualified enhanced oil recovery project or for other activities*. Any cost paid or incurred during the taxable year for an asset which is used to implement more than one qualified enhanced oil recovery project is allocated among the projects in determining the qualified enhanced oil recovery costs for each qualified project for the taxable year. Similarly, any cost paid or incurred during the taxable year for an asset which is used to implement a qualified enhanced oil recovery project and which is also used for other activities (for example, an enhanced oil recovery project that is not a qualified enhanced oil recovery project) is allocated among the qualified enhanced oil recovery project and the other activities to determine the qualified enhanced oil recovery costs for the taxable year. See §1.613–5(a). Any cost paid or incurred for an asset which is used to implement a qualified enhanced oil recovery project and which is also used for other activities is not required to be allocated under this paragraph (a)(2) if the use of the property for nonqualifying activities is *de minimis* (e.g., not greater than 10%). Costs are allocated under this paragraph (a)(2) only if the asset with respect to which the costs are paid or incurred is used for the primary purpose of implementing an enhanced oil recovery project. *See* paragraph (c)

of this section. Any reasonable allocation method may be used. A method that allocates costs based on the anticipated use in a project or activity is a reasonable method.

(b) *Costs defined*—(1) *Qualified tertiary injectant expenses*. For purposes of this section, ''qualified tertiary injectant expenses'' means any costs that are paid or incurred in connection with a qualified enhanced oil recovery project and that are deductible under section 193 for the taxable year. *See* section 193 and § 1.193–1. Qualified tertiary injectant expenses are taken into account in determining the credit with respect to the taxable year in which the tertiary injectant expenses are deductible under section 193.

(2) *Intangible drilling and development costs*. For purposes of this section, ''intangible drilling and development costs'' means any intangible drilling and development costs that are paid or incurred in connection with a qualified enhanced oil recovery project and for which the taxpayer may make an election under section 263(c) for the taxable year. Intangible drilling and development costs are taken into account in determining the credit with respect to the taxable year in which the taxpayer may deduct the intangible drilling and development costs under section 263(c). For purposes of this paragraph (b)(2), the amount of the intangible drilling and development costs for which an integrated oil company may make an election under section 263(c) is determined without regard to section 291(b).

(3) *Tangible property costs*—(i) *In general*. For purposes of this section, ''tangible property costs'' means an amount paid or incurred during a taxable year for tangible property that is an integral part of a qualified enhanced oil recovery project and that is depreciable or amortizable under chapter 1. An amount paid or incurred for tangible property is taken into account in determining the credit with respect to the taxable year in which the cost is paid or incurred.

(ii) *Integral part*. For purposes of this paragraph (b), tangible property is an integral part of a qualified enhanced oil recovery project if the property is used directly in the project and is essential to the completeness of the project. All the facts and circumstances determine whether tangible property is used directly in a qualified enhanced oil recovery project and is essential to the completeness of the project. Generally, property used to acquire or produce the tertiary injectant or property used to transport the tertiary injectant to a project site is property that is an integral part of the project.

(4) *Examples*. The following examples illustrate the principles of this paragraph (b). Assume for each of these examples that the qualified enhanced oil recovery costs are paid or incurred with respect to an asset which is used for the primary purpose of implementing an enhanced oil recovery project.

Example 1. Qualified costs—in general. (i) In 1992, X, a corporation, acquires an operating mineral interest in a property and undertakes a cyclic steam enhanced oil recovery project with respect to the property. X pays a fee to acquire a permit to drill and hires a contractor to drill six wells. As part of the project implementation, X constructs a building to serve as an office on the property and purchases equipment, including downhole equipment (e.g., casing, tubing, packers, and sucker rods), pumping units, a steam generator, and equipment to remove gas and water from the oil after it is produced. X constructs roads to transport the equipment to the wellsites and incurs costs for clearing and draining the ground in preparation for the drilling of the wells. X purchases cars and trucks to provide transportation for monitoring the wellsites. In addition, X contracts with Y for the delivery of water to produce steam to be injected in connection with the cyclic steam project, and purchases storage tanks to store the water.

(ii) The leasehold acquisition costs are not qualified enhanced oil recovery costs. However, the costs of the permit to drill are intangible drilling and development costs that are qualified costs. The costs associated with hiring the contractor to drill, constructing roads, and clearing and draining the ground are intangible drilling and development costs that are qualified enhanced oil recovery costs. The downhole equipment, the pumping units, the steam generator, and the equipment to remove the gas and water from the oil after it is produced are used directly in the project and are essential to the completeness of the project. Therefore, this equipment is an integral part of the project and the costs of the equipment are qualified enhanced oil recovery costs. Although the building that X constructs as an office and the cars and trucks X purchases to provide transportation for monitoring the wellsites are used directly in the project, they are not essential to the completeness of the project. Therefore, the building and the cars and trucks are not an integral part of the project and their costs are not qualified enhanced oil recovery costs. The cost of the water X purchases from Y is a tertiary injectant expense that is a qualified enhanced oil recovery cost. The storage tanks X acquires to store the water are required to provide a proximate source of water for the production of steam. Therefore, the water storage tank are an integral part of the project and the costs of the water storage tanks are qualified enhanced oil recovery costs.

Example 2. Diluent storage tanks. In 1992, A, the owner of an operating mineral interest, undertakes a qualified enhanced oil recovery project with respect to the property. A acquires diluent to be used in connection with the project. A stores the diluent in a storage tank that A acquires for that purpose. The storage tank provides a proximate source of diluent to be used in the tertiary recovery method. Therefore, the storage tank is used directly in the project and is essential to the completeness of the project. Accordingly, the storage tanks is an integral part of the project and the cost of the storage tank is a qualified enhanced oil recovery cost.

Example 3. Oil storage tanks. In 1992, Z, a corporation and the owner of an operating mineral interest in a property, undertakes a qualified enhanced oil recovery project with respect to the property. Z acquires storage tanks that Z will use solely to store the crude oil that is produced from the enhanced oil recovery project. The storage tanks are not used directly in the project and are not essential to the completeness of the project. Therefore, the storage tanks are not an integral part of the enhanced oil recovery project and the costs of the storage tanks are not qualified enhanced oil recovery costs.

Example 4. Oil refinery. B, the owner of an operating mineral interest in a property, undertakes a qualified enhanced oil recovery project with respect to the property. Located on B's property is an oil refinery where B will refine the crude oil produced from the project. The refinery is not used directly in the project and is not essential to the completeness of the project. Therefore, the refinery is not an integral part of the enhanced oil recovery project.

Example 5. Gas processing plant. C, the owner of an operating mineral interest in a property, undertakes a qualified enhanced oil recovery project with respect to the property. A gas processing plant where C will process gas produced in the project is located on C's property. The gas processing plant is not used directly in the project and is not essential to the completeness of the project. Therefore, the gas processing plant is not an integral part of the enhanced oil recovery project.

Example 6. Gas processing equipment. The facts are the same as in *Example 5* except that C uses a portion of the gas processing plant to separate and recycle the tertiary injectant. The gas processing equipment used to separate and recycle the tertiary injectant is used directly in the project and is essential to the completeness of the project. Therefore, the gas processing equipment used to separate and recycle the tertiary injectant is an integral part of the enhanced oil recovery project and the costs of this equipment are qualified enhanced oil recovery costs.

Example 7. Steam generator costs allocated. In 1988, D, the owner of an operating mineral interest in a property, undertook a steam drive project with respect to the property. In 1992, D decides to undertake a steam drive project with respect to reservoir volume that was substantially unaffected by the 1988 project. The 1992 project is a significant expansion that is a qualified enhanced oil recovery project. D purchases a new steam generator with sufficient capacity to provide steam for both the 1988 project and the 1992 project. The steam generator is used directly in the 1992 project and is essential to the completeness of the 1992 project. Accordingly, the steam generator is an integral part of the 1992 project. Because the steam generator is also used to provide steam for the 1988 project, D must allocate the cost of the steam generator to the 1988 project and the 1992 project. Only the portion of the cost of the steam generator that is allocable to the 1992 project is a qualified enhanced oil recovery cost.

Example 8. Carbon dioxide pipeline. In 1992, E, the owner of an operating mineral interest in a property, undertakes an immiscible carbon dioxide displacement project with respect to the property. E constructs a pipeline to convey carbon dioxide to the project site. E contracts with F, a producer of carbon dioxide, to purchase carbon dioxide to be injected into injection wells in E's enhanced oil recovery project. The cost of the carbon dioxide is a tertiary injectant expense that is a qualified enhanced oil recovery cost. The pipeline is used by E to transport the tertiary injectant, that is, the carbon dioxide to the project site. Therefore, the pipeline is an integral part of the project. Accordingly, the cost of the pipeline is a qualified enhanced oil recovery cost.

Example 9. Water source wells. In 1992, G the owner of an operating mineral interest in a property, undertakes a polymer augmented waterflood project with respect to the property. G drills water wells to provide water for injection in connection with the project. The costs of drilling the water wells are intangible drilling and development costs that are paid or incurred in connection with the project. Therefore, the costs of drilling the water wells are qualified enhanced oil recovery costs.

Example 10. Leased equipment. In 1992, H, the owner of an operating mineral interest in a property undertakes a steam drive project with respect to the property. H contracts with I, a driller, to drill injection wells in connection with the project. H also leases a steam generator to provide steam for injection in connection with the project. The drilling costs are intangible drilling and development costs that are paid in connection with the project and are qualified enhanced oil recovery costs. The steam generator is used to produce the tertiary injectant. The steam generator is used directly in the project and is essential to the completeness of the project; therefore, it is an integral part of the project. The costs of leasing the steam generator are tangible property costs that are qualified enhanced oil recovery costs.

(c) *Primary purpose*—(1) *In general*. For purposes of this section, a cost is a qualified enhanced oil recovery cost only if the cost is paid or incurred with respect to an asset which is used for the primary purpose of implementing one or more enhanced oil recovery projects, at least one of which is a qualified enhanced oil recovery project. All the facts and circumstances determine whether an asset is used for the primary purpose of implementing an enhanced oil recovery project. For purposes of this paragraph (c), an enhanced oil recovery project is a project that satisfies the requirements of paragraphs (a) (1) and (2) of section 1.43–2.

(2) *Tertiary injectant costs*. Tertiary injectant costs generally satisfy the primary purpose test of this paragraph (c).

(3) *Intangible drilling and development costs*. Intangible drilling and development costs paid or incurred with respect to a well that is used in connection with the recovery of oil by primary or secondary methods are not qualified enhanced oil recovery costs. Except as provided in this paragraph (c)(3), a well used for primary or secondary recovery is not used for the primary purpose of implementing an enhanced oil recovery project. A well drilled for the primary purpose of implementing an enhanced oil recovery project is not considered to be used for primary or secondary recovery, notwithstanding that some primary or secondary production may result when the well is drilled, provided that such primary or secondary production is consistent with the unit plan of development or other similar plan. All the facts and circumstances determine whether primary or secondary recovery is consistent with the unit plan of development or other similar plan.

(4) *Tangible property costs*. Tangible property costs must be paid or incurred with respect to property which is used for the primary purpose of implementing an enhanced oil recovery project.

If tangible property is used partly in a qualified enhanced oil recovery project and partly in another activity, the property must be primarily used to implement the qualified enhanced oil recovery project.

(5) *Offshore drilling platforms*. Amounts paid or incurred in connection with the acquisition, construction, transportation, erection, or installation of an offshore drilling platform (regardless of whether the amounts are intangible drilling and development costs) that is used in connection with the recovery of oil by primary or secondary methods are not qualified enhanced oil recovery costs. An offshore drilling platform used for primary or secondary recovery is not used for the primary purpose of implementing an enhanced oil recovery project.

(6) *Examples*. The following examples illustrate the principles of this paragraph (c).

Example 1. Intangible drilling and development costs. In 1992, J incurs intangible drilling and development costs in drilling a well. J intends to use the well as an injection well in connection with an enhanced oil recovery project in 1994, but in the meantime will use the well in connection with a secondary recovery project. J may not take the intangible drilling and development costs into account in determining the credit because the primary purpose of a well used for secondary recovery is not to implement a qualified enhanced oil recovery project.

Example 2. Offshore drilling platform. K, the owner of an operating mineral interest in an offshore oil field located within the United States, constructs an offshore drilling platform that is designed to accommodate the primary, secondary, and tertiary development of the field. Subsequent to primary and secondary development of the field, K commences an enhanced oil recovery project that involves the application of a qualified tertiary recovery method. As part of the enhanced oil recovery project, K drills injection wells from the offshore drilling platform K used in the primary and secondary development of the field and installs an additional separator on the platform.

Because the offshore drilling platform was used in the primary and secondary development of the field and was not used for the primary purpose of implementing tertiary development of the field, costs incurred by K in connection with the acquisition, construction, transportation, erection, or installation of the offshore drilling platform are not qualified enhanced oil recovery costs. However, the costs K incurs for the additional separator are qualified enhanced oil recovery costs because the separator is used for the primary purpose of implementing tertiary development of the field. In addition, the intangible drilling and development costs K incurs in connection with drilling the injection wells are qualified enhanced oil recovery costs with respect to which K may claim the enhanced oil recovery credit.

(d) *Costs paid or incurred prior to first injection*—(1) *In general.* Qualified enhanced oil recovery costs may be paid or incurred prior to the date of the first injection of liquids, gases, or other matter (within the meaning of §1.43–2(c)). If the first injection of liquids, gases, or other matter occurs on or before the date the taxpayer files the taxpayer's federal income tax return for the taxable year with respect to which the costs are allowable, the costs may be taken into account on that return. If the first injection of liquids, gases, or other matter is expected to occur after the date the taxpayer files that return, costs may be taken into account on that return if the Internal Revenue Service issues a private letter ruling to the taxpayer that so permits.

(2) *First injection after filing of return for taxable year costs are allowable.* Except as provided in paragraph (d)(3) of this section, if the first injection of liquids, gases, or other matter occurs or is expected to occur after the date the taxpayer files the taxpayer's federal income tax return for the taxable year with respect to which the costs are allowable, the costs may be taken into account on an amended return (or in the case of a Coordinated Examination Program taxpayer, on a written statement treated as a qualified return) after the earlier of—

(i) The date the first injection of liquids, gases, or other matter occurs; or

(ii) The date the Internal Revenue Service issues a private letter ruling that provides that the taxpayer may take costs into account prior to the first injection of liquids, gases, or other matter.

(3) *First injection more than 36 months after close of taxable year costs are paid or incurred.* If the first injection of liquids, gases, or other matter occurs more than 36 months after the close of the taxable year in which costs are paid or incurred, the taxpayer may take the costs into account in determining the credit only if the Internal Revenue Service issues a private letter ruling to the taxpayer that so provides.

(4) *Injections in volumes less than the volumes specified in the project plan.* For purposes of this paragraph (d), injections in volumes significantly less than the volumes specified in the project plan, the unit plan of development, or another similar plan do not constitute the first injection of liquids, gases, or other matter.

(5) *Examples.* The following examples illustrate the provisions of paragraph (d) of this section.

Example 1. First injection before return filed. In 1992, L, a calendar year taxpayer, undertakes a qualified enhanced oil recovery project on a property in which L owns an operating mineral interest. L incurs $1,000 of intangible drilling and development costs, which L may elect to deduct under section 263(c) for 1992. The first injection of liquids, gases, or other matter (within the meaning of §1.43–2(c)) occurs in March 1993. L files a 1992 federal income tax return in April 1993. Because the first injection occurs before the filing of L's 1992 federal income tax return, L may take the $1,000 of intangible drilling and development costs into account in determining the credit for 1992 on that return.

Example 2. First injection after return filed. In 1993, M, a calendar year taxpayer, undertakes a qualified enhanced oil recovery project on a property in which M owns an operating mineral interest. M incurs $2,000 of intangible drilling and development costs, which M elects to deduct under section 263(c) for 1993. The first injection of liquids, gases, or other matter is expected to occur in 1995. M files a 1993 federal income tax return in April 1994. Because the first injection of liquids, gases, or other matter occurs after the date on which M's 1993 federal income tax return is filed in April 1994, M may take the $2,000 of intangible drilling and development costs into account on an amended return for 1993 after the earlier of the date the first injection of liquids, gases, or other matter occurs, or the date the Internal Revenue Service issues a private letter ruling that provides that M may take the $2,000 into account prior to first injection.

Example 3. First injection more than 36 months after taxable year. N, a calendar year taxpayer, owns an operating mineral interest in a property on which N undertakes an immiscible carbon dioxide displacement project. In 1994, N incurs $5,000 in connection with the construction of a pipeline to transport carbon dioxide to the project site. The first injection of liquids, gases, or other matter is expected to occur after the pipeline is completed in 1998. Because the first injection of liquids, gases, or other matter occurs more than 36 months after the close of the taxable year in which the $5,000 is incurred, N may take the $5,000 into account in determining the credit only if N receives a private letter ruling from the Internal Revenue Service that provides that N may take the $5,000 into account prior to first injection.

(e) *Other rules*—(1) *Anti-abuse rule.* Costs paid or incurred with respect to an asset that is acquired, used, or transferred in a manner designed to duplicate or otherwise unreasonably increase the amount of the credit are not qualified enhanced oil recovery costs, regardless of whether the costs would otherwise be creditable for a single taxpayer or more than one taxpayer.

(2) *Costs paid or incurred to acquire a project.* A purchaser of an existing qualified enhanced oil recovery project may claim the credit for any section 43 costs in excess of the acquisition cost. However, costs paid or incurred to acquire an existing qualified enhanced oil recovery project (or an interest in an existing qualified enhanced oil recovery project) are not eligible for the credit.

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

Example 1. Duplicating or unreasonably increasing the credit. O owns an operating mineral interest in a property with respect to which a qualified enhanced oil recovery project is implemented. O acquires pumping units, rods, casing, and separators for use in connection with the project from an unrelated equipment dealer in an arm's length transaction. The equipment is used for the primary purpose of implementing the project. Some of the equipment acquired by O is used equipment. The costs paid by O for the used equipment are qualified enhanced oil recovery costs. O does not need to determine whether the equipment has been previously used in an enhanced oil recovery project.

Example 2. Duplicating or unreasonably increasing the credit. P and Q are co-owners of an oil property with respect to which a qualified enhanced oil recovery project is implemented. In 1992, P and Q jointly purchase a nitrogen plant to supply the tertiary injectant used in the project. P and Q claim the credit for their respective costs for the plant. In 1994, X, a corporation unrelated to P or Q, purchases the nitrogen plant and enters into an agreement to sell nitrogen to P and Q. Because this transaction duplicates or otherwise unreasonably increases the credit, the credit is not allowable for the amounts incurred by P and Q for the nitrogen purchased from X.

Example 3. Duplicating or unreasonably increasing the credit. The facts are the same as in *Example 2.* In addition, in 1995, P and Q reacquire the nitrogen plant from X. This constitutes the acquisition of property in a manner designed to duplicate or otherwise unreasonably increase the amount of the credit. Therefore, the credit is not allowable for amounts incurred by P and Q for the nitrogen plant purchased from X.

Example 4. Duplicating or unreasonably increasing the credit. R owns an operating mineral interest in a property with respect to which a qualified enhanced oil recovery project is implemented. R acquires a pump that is installed at the site of the project. After the pump has been placed in service for 6 months, R transfers the pump to a secondary recovery project and acquires a replacement pump for the tertiary project. The original pump is suited to the needs of the secondary recovery project and could have been installed there initially. The pumps have been acquired in a manner designed to duplicate or otherwise unreasonably increase the amount of the credit. Depending on the facts, the cost of one pump or the other may be a qualified enhanced oil recovery cost; however, R may not claim the credit with respect to the cost of both pumps.

Example 5. Acquiring a project. In 1993, S purchases all of T's interest in a qualified enhanced oil recovery project, including all of T's interest in tangible property that is an integral part of the project and all of T's operating mineral interest. In 1994, S incurs costs for additional tangible property that is an integral part of the project and which is used for the primary purpose of implementing the project. S also incurs costs for tertiary injectants that are injected in connection with the project. In determining the credit for 1994, S may take into account costs S incurred for tangible property and tertiary injectants. However, S may not take into account any amount that S paid for T's interest in the project in determining S's credit for any taxable year.

[T.D. 8448, 57 FR 54927, Nov. 23, 1992; 58 FR 7987, Feb. 11, 1993]

§ 1.43–5 At-risk limitation. [Reserved]

§ 1.43–6 Election out of section 43.

(a) *Election to have the credit not apply*—(1) *In general.* A taxpayer may elect to have section 43 not apply for any taxable year. The taxpayer may revoke an election to have section 43 not apply for any taxable year. An election to have section 43 not apply (or a revocation of an election to have section 43 not apply) for any taxable year is effective only for the taxable year to which the election relates.

(2) *Time for making the election.* A taxpayer may make an election under paragraph (a) of this section to have section 43 not apply (or revoke an election to have section 43 not apply) for any taxable year at any time before the expiration of the 3-year period beginning on the last date prescribed by law (determined without regard to extensions) for filing the return for the taxable year. The time for making the election (or revoking the election) is prescribed by section 43(e)(2) and may not be extended under § 1.9100–1.

(3) *Manner of making the election.* An election (or revocation) under paragraph (a)(1) of this section is made by attaching a statement to the taxpayer's federal income tax return or an amended return (or, in the case of a Coordinated Examination Program taxpayer, on a written statement treated as a qualified amended return) for the taxable year for which the election (or revocation) applies. The taxpayer must indicate whether the taxpayer is electing to not have section 43 apply or is revoking such an election and designate the project or projects to which the election (or revocation) applies. For any taxable year, the last election (or revocation) made by a taxpayer within the period prescribed in paragraph (a)(2) of this section determines whether section 43 applies for that taxable year.

(b) *Election by partnerships and S corporations.* For partnerships and S corporations, an election to have section 43 not apply (or a revocation of an election to have section 43 not apply) for any taxable year is made, in accordance with the requirements of paragraph (a) of this section, by the partnership or S corporation with respect to the qualified enhanced oil recovery costs paid or incurred by the partnership or S corporation for the taxable year to which the election relates.

[T.D. 8448, 57 FR 54930, Nov. 23, 1992]

§ 1.43–7 Effective date of regulations.

The provisions of §§ 1.43–1, 1.43–2 and 1.43–4 through 1.43–7 are effective with respect to costs paid or incurred after December 31, 1991, in connection with a qualified enhanced oil recovery project. The provisions of § 1.43–3 are effective for taxable years beginning after December 31, 1990. For costs paid or incurred after December 31, 1990, and before January 1, 1992, in connection with a qualified enhanced oil recovery project, taxpayers must take reasonable return positions taking into consideration the statute and its legislative history.

[T.D. 8448, 57 FR 54931, Nov. 23, 1992]

§ 1.44–1 Allowance of credit for purchase of new principal residence after March 12, 1975, and before January 1, 1977.

(a) *General rule.* Section 44 provides a credit against the tax imposed by chapter 1 of the Internal Revenue Code of 1954 in the case of an individual who purchases a new principal residence (as defined in paragraph (a) of § 1.44–5) which is property to which section 44 applies (as provided in § 1.44–2). Subject to the limitations set forth in paragraph (b) of this section, the credit is in an amount equal to 5 percent of the purchase price (as defined in paragraph (b) of § 1.44–5).

(b) *Limitations*—(1) *Maximum credit.* The credit allowed under section 44 and this section may not exceed $2,000.

(2) *Limitation to one residence.* Such credit shall be allowed with respect to only one residence of the taxpayer; the combined purchase prices of more than one new principal residence cannot be aggregated to increase the credit allowed.

(3) *Married individuals.* In the case of a husband and wife who file a joint return under section 6013, the maximum credit allowed on the joint return is $2,000. In the case of married individuals filing separate returns the maximum credit allowable to each spouse is $1,000. Where a husband and wife do not make equal contributions with respect to the purchase price of the new principal residence, allocation of the credit is to be made in proportion to their respective ownership interests in such residence. For this purpose, tenants by the entirety or joint tenants with right of survivorship are treated as equal owners.

(4) *Certain other taxpayers.* Where a new principal residence is purchased by two or more taxpayers (other than a husband and wife), the amount of the credit allowed will be allocated among the taxpayers in proportion to their respective ownership interests in such residence, with the limitation that the sum of the credits allowed to all such taxpayers shall not exceed $2,000. For this purpose, joint tenants with right of survivorship are treated as equal owners. For an example of the operation of this provision see *Example (2)* of § 1.44–5(b)(2)(ii).

(5) *Application with other credits.* The credit allowed by this section shall not exceed the amount of the tax imposed by chapter 1 of the Code for the taxable year, reduced by the sum of the credits allowable under—

(i) Section 33 (relating to taxes of foreign countries and possessions of the United States),

(ii) Section 37 (relating to retirement income),

(iii) Section 38 (relating to investment in certain depreciable property),

(iv) Section 40 (relating to expenses of work incentive program),

(v) Section 41 (relating to contributions to candidates for public office), and

(vi) Section 42 (relating to personal exemptions).

[T.D. 7391, 40 FR 55851, Dec. 2, 1975]

§ 1.44–2 Property to which credit for purchase of new principal residence applies.

The provisions of section 44 and the regulations thereunder apply to a new principal residence which satisfies the following conditions:

(a) *Construction.* The construction of the residence must have begun before March 26, 1975. For this purpose construction is considered to have commenced in the following circumstances:

(1)(i) Except as provided in subparagraph (2) of this paragraph, construction is considered to commence when actual physical work of a significant amount has occurred on the building site of the residence. A significant amount of construction requires more than drilling to determine soil conditions, preparation of an architect's sketches, securing of a building permit, or grading of the land. Land preparation and improvements such as the clearing and grading (excavation or filling), construction of roads and sidewalks, and installation of sewers and utilities are not considered commencement of construction of the residence even though they might involve a significant expenditure. However, driving pilings for the foundation, digging of the footings, excavation of the building foundation, pouring of floor slabs, or construction of compacted earthen pads when specifically prepared and designed for a particular residential structure and not merely as a part of the overall land preparation, constitute a significant amount of construction of the residence. In the case of a housing or condominium development construction of recreational facilities no matter how extensive does not by itself constitute commencement of construction of any residential unit. However, where residential units are part of a building structure, as in the case of certain condominium and cooperative housing units, then digging of the footings or excavation of the building foundation constitutes commencement of construction for all units in that building.

(ii) The rules in subdivision (i) of this subparagraph are illustrated by the following examples:

Example 1. A location chosen for a housing development has extremely hilly terrain. In order to make the location suitable for development, the builder moves large amounts of earth and places it elsewhere on the location. In addition, the earth material which has been moved must be compacted according to government specifications in order to provide a stable base. Such activities constitute land preparation and, therefore, do not constitute the commencement of construction.

Example 2. A location chosen for a housing development has swampy and marshy terrain. In order to make the location suitable for development the builder utilizes large quantities of fill. This activity constitutes land preparation and does not constitute commencement of construction.

Example 3. Assume the same facts as in either *Example 1* or *Example 2* except that the builder also constructs an earthen pad of compacted fill specifically prepared for a particular residential structure and not merely as a part of the overall land preparation. Construction of the compacted earthen pad is considered in the same light as excavation of the building foundation and accordingly constitutes commencement of construction.

(2) Construction of a factory-made home (as defined in paragraph (e) of §1.44–5) is considered to have commenced when construction of important parts of the factory-made home has commenced. For this purpose, commencement of construction of important parts means the cutting and shaping or welding of structural components for a specific identifiable factory-made home, whether the work was done by the manufacturer of the home or by a subcontractor thereof.

(b) *Acquisition and occupancy.* The residence must be acquired and occupied by the taxpayer after March 12, 1975, and before January 1, 1977. For this purpose a taxpayer ''acquires'' a residence when legal title to it is conveyed to him at settlement, or he has possession of it pursuant to a binding purchase contract under which he makes periodic payments until he becomes entitled under the contract to demand conveyance of title. A taxpayer ''occupies'' a residence when he or his spouse physically occupies it. Thus, for example, moving of furniture or other household effects into the residence or physical occupancy by a dependent child of the taxpayer is not ''occupancy'' for purposes of this paragraph. The credit may be claimed when both the acquisition and occupancy tests have been satisfied. Thus, where a taxpayer meets the acquisition and occupancy tests set forth above after March 12, 1975, and before January 1, 1976, the credit is allowable for 1975. Where a taxpayer occupied a residence prior to March 13, 1975, without having acquired it (as where his occupancy was pursuant to a leasing arrangement pending settlement under a binding contract to purchase or pursuant to a leasing arrangement where a written option to purchase was contained in the original lease agreement) he will nonetheless satisfy the acquisition and occupancy tests set forth above if he acquires the residence and continues to occupy it after March 12, 1975, and before January 1, 1977.

(c) *Binding contract.* Except in the case of self-construction, the new principal residence must be acquired by the taxpayer (within the meaning of paragraph (b) of this section) under a binding contract entered into by the taxpayer before January 1, 1976. An otherwise binding contract for the purchase of a residence which is conditioned upon the purchaser's obtaining a loan for the purchase of the residence (including conditions as to the amount or interest rate of such loan) is considered binding notwithstanding that condition.

(d) *Self-constructed residence.* A self-constructed residence (as defined in paragraph (d) of §1.44–5) must be occupied by the taxpayer before January 1, 1977. Where self-construction of a principal residence was begun before March 13, 1975, only that portion of the basis of the property allocable to construction after March 12, 1975, and before January 1, 1977, shall be taken into consideration in determining the amount of the credit allowable. For this purpose, the portion of the basis attributable to the pre-March 13 period includes the total cost of land acquired (as defined in paragraph (b) of this section) prior to March 13, 1975, on which the new principal residence is constructed and the cost of expenditures with respect to construction work performed prior to March 13, 1975. The costs incurred in stockpiling materials for later stages of construction, however, are not allocated to the pre-March 13 period. Thus, for example, if prior to March 13, 1975, a taxpayer who qualifies for the credit has constructed a portion of a residence at a cost of $10,000 (including the cost of the land purchased prior to March 13, 1975) and the total cost of the residence is $40,000 and the taxpayer's basis after the application of section 1034(e) (relating to the reduction of basis of new principal residence where gain is not recognized upon the sale of the old residence) is $36,000, the amount subject to the credit will be $27,000:

($30,000 ÷ $40,000) × $36,000.

[T.D. 7391, 40 FR 55852, Dec. 2, 1975; 40 FR 58138, Dec. 15, 1975]

§ 1.44–3 Certificate by seller.

(a) *Requirement of certification by seller.* Taxpayers claiming the credit should attach Form 5405, Credit for Purchase or Construction of New Principal Residence, to their tax returns on which the credit is claimed. Except in the case of self-construction (as defined in § 1.44–5(d)), taxpayers must attach a certification by the seller that construction of the residence began before March 26, 1975, and that the purchase price is the lowest price at which the residence was offered for sale after February 28, 1975. For purposes of section 44(e)(4) and this section, the term "price" generally does not include costs of acquisition other than the amount of the consideration from the purchaser to the seller. However, for rules relating to adjustments in price due to changes in financing terms and closing costs see paragraph (d)(2) of this section.

(b) *Form of certification.* The following form of the certification statement is suggested:

I certify that the construction of the residence at (specify address) was begun before March 26, 1975, and that this residence has not been offered for sale after February 28, 1975 in a listing, a written private offer, or an offer by means of advertisement at a lower purchase price than (state price), the price at which I sold the residence to (state name, present address, and social security number of purchaser) by contract dated (give date).

(Date, seller's signature and taxpayer identification number.)

However, any written certification filed by the taxpayer will be accepted provided that such certification is signed by the seller and states that construction of the residence began before March 26, 1975, and that the purchase price of the residence is the lowest price at which the residence was offered for sale after February 28, 1975. With regard to factory-made homes the seller, in the absence of his own knowledge as to the commencement of construction, may attach to his own certification a certification from the manufacturer that construction began before March 26, 1975, and may certify based on the manufacturer's certification. It is suggested that both certifications include the serial number, if any, of the residence.

(c) *Offer to sell.* (1) For purposes of section 44(e)(4) and this section, an offer to sell is limited to an offer to sell a specified residence at a specified purchase price.

(2) An "offer" includes any written offer, whether made to a particular purchaser or to the public, and any offer by means of advertising. Advertising includes an offer to sell published by billboards, flyers, brochures, price lists (unless the lists are exclusively for the internal use of the seller and are not made available to the public), mailings, newspapers, periodicals, radio, or television. The listing of a property with a real estate agency, the filing of a prospectus and the registration of construction plans and price lists with the appropriate authorities (in the case of condominiums or cooperative housing developments) are to be considered offers made to the public.

(3) An offer to sell a specified residence includes:

(i) Both an offer to sell an existing residence and an offer to build and sell a residence of substantially the same design or model as that purchased by the taxpayer on the same lot as that on which the taxpayer's new principal residence was constructed. It does not include an offer to sell the same model residence on a different lot. Where a residence of a particular design or model is offered at a specific base price, additions of property to the residence, no matter how extensive, will not result in the residence being treated as a different residence for the purpose of determining the lowest offer (as defined in paragraph (f) of § 1.44–5).

(ii) In the case of a condominium or cooperative housing development where units are offered for sale on the basis of models (e.g., all Model C two-bedroom apartments sell at a specified base price), an offer to sell a specified residence includes an offer to sell a specific type of unit (with appropriate adjustments to be made for the location of such unit and as provided in paragraph (d) of this section).

(iii) In the case of a factory-made home, an offer to sell a specified residence includes an offer to sell the same model home as that purchased by the taxpayer, provided that the offer is made after the seller has the right to sell the home purchased by the taxpayer (*i.e.*, has that specific home in his inventory). However, it does not include an offer to sell such home with land which is not included in the taxpayer's purchase nor an offer to sell such home without land which is included in the taxpayer's purchase. Appropriate adjustments to a prior offer shall be made as provided in paragraph (d) of this section, including adjustments for any delivery and installation charges as provided in paragraph (d)(3).

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

Example 1. In March 1975 A advertised colonial-style homes on section I of subdivision C at a base price of $40,000. At the time none of the homes had been completed but construction of all homes on section I was commenced before March 26, 1975. After one-half of the homes were sold, A offers to sell the remaining homes in May 1975 at a base price of $45,000. Under the facts above the base price of $45,000 is not the lowest offer since the seller had offered to sell the same model home on the same lot at a lower purchase price after February 28, 1975.

Example 2. In June 1975 A offers houses, otherwise qualifying, on section II for the first time for a base price of $50,000. They are colonial homes and substantially the same as the homes he previously offered on section I. Under the facts stated above the base price of $50,000 is the lowest offer since the same model home on the same lot was not previously offered for sale.

Example 3. In March 1975 B, a condominium developer, offers to sell any two-bedroom unit in a particular high rise condominium for $45,000 with an added $5,000 for units with a lakefront view and an additional $2,000 for units on higher floors. With regard to all two-bedroom units in the condominium an offer to sell a specified residence at a specified purchase price has been made. This is true even though at the time of the offer construction had not reached the floor on which the particular unit will be located.

(4) A specified purchase price means a stated definite price for a particular residence or a specific base price for a residence of a particular model or design. An offer to sell for an indefinite price (e.g., an advertisement that all houses sell in the $40,000's) is not considered an offer to sell at a specified purchase price.

(5) An offer to sell includes an offer to sell subject to special conditions imposed by the seller. Thus, if the lowest price at which a house was advertised was ''at $40,000 for March only'', the $40,000 price would be the lowest offer. However, certain conditions may necessitate adjustments in determining the lowest offer. See paragraph (d) of this section.

(6) An offer to sell two or more residences together as for example, in a bulk sale shall be disregarded, even though each residence is assigned a specific purchase price for the purpose of such a sale. With regard to factory-made homes an offer to sell does not include an offer made by the manufacturer to a dealer in such homes.

(7)(i) Where new residences are purchased at a foreclosure sale (including a conveyance by the owner in lieu of foreclosure) and prior to the foreclosure sale such residences had been offered for sale by the foreclosure seller at specified prices, the foreclosure purchaser is bound by such prices in determining the lowest offer. He is not bound by the prices paid to the foreclosure seller since such prices do not constitute voluntary offers.

(ii) For this purpose, if the foreclosure seller and foreclosure purchaser are not related parties (as defined in subdivision (iii) of this subparagraph), and if the foreclosure purchaser does not have knowledge of the date of commencement of construction and the lowest offer made by such seller with respect to each of the foreclosed residences, the foreclosure purchaser must request and try to obtain from the foreclosure seller a certificate specifying such facts. Upon a subsequent sale of a particular residence by the foreclosure purchaser, he must certify whether the price is the lowest offer for that particular residence based on the certification of the foreclosure seller, a copy of which must be attached to the certification of the foreclosure purchaser. If the foreclosure seller refuses to so certify, the foreclosure purchaser must make a reasonable effort to determine the date construction commenced and the lowest offer made by the foreclosure seller. For this purpose, reasonable effort includes the effort to locate and examine advertising and listings published or used by the foreclosure seller. If the foreclosure seller and foreclosure purchaser are related parties (as defined in subdivision (iii) of this subparagraph), the foreclosure purchaser will be considered as having knowledge of the date of the commencement of construction and the lowest offer made by such seller with respect to each of the foreclosed residences, and, upon a subsequent sale of a particular residence by the foreclosure purchaser, he must comply with the certification requirements prescribed by paragraphs (a) and (b) of this section.

(iii) For purposes of this subparagraph related parties shall include the relationships described in subparagraph (2) of §1.44–5(c), and the constructive ownership rules of section 318 shall apply, but family members for this purpose shall include spouses, ancestors, and lineal descendants.

(d) *Adjustments in determining lowest price.* (1)(i) In determining whether a residence was sold at the lowest offer appropriate adjustment shall be made for differences in the property offered and in the terms of the sale. Where the sale to the taxpayer includes property which was not the subject of the prior offer or excludes property which was included in the prior offer, the amount of the prior offer shall be adjusted to reflect the fair market value of such property, provided that, in the case of property included in the sale which was not a part of the residence at the time of execution of the contract of purchase, the taxpayer had the option to require inclusion or exclusion of such property. The fair market value of any excluded property is to be determined at the time of the prior offer, while all additions are to be valued at their fair market value on the date of execution of the contract of sale. If a seller increases his present offer to include financing or other costs of the seller in connection with his ownership of the residence, the present offer does not qualify as being the lowest offer.

(ii) The rules in subdivision (i) of this subparagraph are illustrated by the following examples:

Example 1. A offered to sell a new home without a garage for $35,000. Having found no buyers A added a garage and sold the home for $40,000. At the time the contract of sale was executed the fair market value of the garage was $5,000. The offer to sell for $40,000 qualifies since it equals the seller's lowest offer plus the fair market value of the garage.

Example 2. B, unable to sell colonial-style homes presently under construction and previously offered for sale for $40,000, makes extensive changes in decor and identifies the homes as his new Williamsburg model. The Williamsburg models are not different residences for purposes of this section. To the extent that the additions have not yet been added at the time of execution of a contract of sale, in order to qualify for the credit the taxpayer must have the option as to whether to include these additions, and if these additions are included B must charge no more than the fair market value of the additions on that date of execution of the contract of sale.

(2) Appropriate adjustment to a prior offer to sell shall be made for differences in financing terms and closing costs which increase the seller's actual net proceeds and the purchaser's actual costs. A seller may pass on to the purchaser without affecting the purchase price only those additional amounts he is required to expend in connection with such differences. The seller may not by changing the financing terms or closing costs indirectly increase the purchase price. For these purposes closing costs include all charges paid at settlement for obtaining the mortgage loan and transferring real estate title. Thus, for example, where a seller previously offered a residence for sale for $40,000 and agreed to pay financing "points" required by the mortgagee, and now offers the same residence also for $40,000 but requires the purchaser to pay the points, the present offer does not constitute the lowest offer. On the other hand, a prior offer to sell based upon a large down payment by the prospective purchaser may be adjusted to

reflect the additional costs to the seller of accepting a small down payment from the taxpayer. For purposes of determining the seller's net proceeds, proceeds received by all related parties within the meaning of section 318 must be taken into account. For purposes of determining the lowest offer, where an offer provided for a rebate (e.g., of cash or of a contribution toward mortgage payments) or included, without additional charge or at less than fair market value, property not normally included in the sale of a residence (e.g., an automobile), such offer must be reduced by the amount of such rebate or by the amount by which the fair market value of such property at the time of the offer exceeds the amount paid for it by the purchaser. Thus, where a residence was advertised for sale at $40,000, but the seller agreed to pay $200 a month on the purchaser's mortgage for 10 months, such residence is considered to have been offered for sale at $38,000.

(3) In the case of a factory-made home, where delivery and installation costs are included in the specified base price of such home an appropriate adjustment is to be made in such specified base price for differences in the fair market value of the delivery and installation in determining the lowest offer.

(e) *Civil and criminal penalties.* If a person certifies that the price for which the residence was sold does not exceed the lowest offer and if it is found that the price for which the residence was sold exceeded the lowest offer, then such person is liable (under section 208(b) of the Tax Reduction Act of 1975) to the purchaser for damages in an amount equal to three times the excess of the certified price over the lowest offer plus reasonable attorney's fees. No income tax deduction shall be allowed for two-thirds of any amount paid or incurred pursuant to a judgment entered against any person in a suit based on such liability. However, attorney's fees, court costs, and other such amounts paid or incurred with respect to such suit which meet the requirements of section 162 are deductible under that section. In addition, an individual who falsely certifies may be subject to criminal penalties. For example, section 1001 of title 18 of the United States Code provides as follows:

§ 1001

Statements or entries generally.

Whoever, in any matter within the jurisdiction of any department or agency of the United States knowingly and willfully falsifies, conceals or covers up by any trick, scheme, or device a material fact, or makes any false, fictitious or fraudulent statements or representations, or makes or uses any false writing or document knowing the same to contain any false, fictitious or fraudulent statement or entry, shall be fined not more than $10,000 or imprisoned not more than five years, or both.

The treble damages and criminal sanctions provided under this paragraph apply only with regard to false certification as to the lowest offer, not to false certification as to commencement of construction. However, with regard to false certification as to commencement of construction there may exist contractual or tort remedies under State law.

(f) *Denial of credit.* In the absence of the taxpayer's participation in, or knowledge of, a false certification by the seller, the credit is not denied to a taxpayer who otherwise qualifies for the credit solely because the seller has falsely certified that the new principal residence was sold at the lowest offer. However, if certification as to the commencement of construction is false, no credit is allowed since such residence does not qualify as a new principal residence construction of which began before March 26, 1975.

[T.D. 7391, 40 FR 55852, Dec. 2, 1975]

§ 1.44–4 Recapture for certain dispositions.

(a) *In general.* (1) Under section 44(d) except as provided in paragraphs (b) and (c) of this section, if the taxpayer disposes of property, with respect to the purchase of which a credit was allowed under section 44(a), at any time within 36 months after the date on which he acquired it (or, in the case of construction by the taxpayer, the date on which he first occupied it as his principal residence), then the tax imposed under chapter 1 of the Code for the taxable year in which the replacement period (as provided under subparagraph (2) of this paragraph) terminates is increased by an amount equal to the amount allowed as a credit for the purchase of such property.

(2) The replacement period is the period provided for purchase of a new principal residence under section 1034 of the Code without recognition of gain on the sale of the old residence. In the case of residences sold or exchanged after December 31, 1974, it is generally 18 months in the case of acquisition by purchase and 2 years in the case of construction by the taxpayer provided, however, that such construction has commenced within the 18-month period. Thus, a calendar-year taxpayer who disposes of his old principal residence in December 1975 and does not qualify under paragraph (b) or (c) of this section will include the amount previously allowed as additional tax on his 1977 tax return.

(3) Except as provided in paragraphs (b) and (c) of this section, section 44(d) applies to all dispositions of property, including sales (including foreclosure sales), exchanges (including tax-free exchanges such as those under sections 351, 721, and 1031), and gifts.

(4) In the case of a husband and wife who were allowed a credit under section 44(a) claimed on a joint return, for the purpose of section 44(d) and this section the credit shall be allocated between the spouses in accordance with the provisions of paragraph (b)(3) of §1.44–1.

(b) *Acquisition of a new residence.* (1) Section 44(d)(1) and paragraph (a) of this section shall not apply to a disposition of property with respect to the purchase of which a credit was allowed under section 44(a) in the case of a taxpayer who purchases or constructs a new principal residence (within the meaning of §1.44–5(a)) within the applicable replacement period provided in section 1034. In determining whether a new principal residence qualifies for purposes of this section the rules relating to construction, acquisition, and occupancy under §1.44–2 do not apply. Where a disposition has occurred and the taxpayer's purchase (or construction) costs of a new principal residence are less than the adjusted sales price (as defined in section 1034(b)) of the old residence, the tax imposed by chapter 1 of the Code for the taxable year following the taxable year during which disposition occurs is increased by an amount which bears the same ratio to the amount allowed as a credit for the purchase of the old residence as (i) the adjusted sales price of the old residence (within the meaning of section 1034), reduced (but not below zero) by the taxpayer's cost of purchasing (or constructing) the new residence (within the meaning of such section) bears to (ii) the adjusted sales price of the old residence.

(2) The rules of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. On July 15, 1975, A purchases a new principal residence for a total purchase price of $40,000. The property meets the tests of §1.44–2, and A is allowed a credit of $2,000 on his 1975 tax return. On January 15, 1977 (within 36 months after acquisition) A sells his residence for an adjusted sales price of $50,000 and on March 15, 1977, purchases a new principal residence at a cost of $40,000. Since the new principal residence was purchased within the 18-month replacement period (provided in section 1034), the amount recaptured is limited to $400, determined by multiplying the amount of the credit allowed ($2,000) by a fraction, the numerator of which is $10,000 (determined by reducing the adjusted sales price of the old residence ($50,000) by A's cost of purchasing the new principal residence ($40,000)) and the denominator of which is $50,000 (the adjusted sales price). Therefore, A's tax liability for 1978, the year following the taxable year in which the disposition occurred, is increased by $400.

(c) *Certain involuntary dispositions.* Section 44(d)(1) and paragraph (a) of this section shall not apply to the following:

(1) A disposition of a residence made on account of the death of any individual having a legal or equitable interest therein occurring during the 36-month period described in paragraph (a) of this section,

(2) A disposition of the residence if it is substantially or completely destroyed by a casualty described in section 165(c)(3),

(3) A disposition of the residence if it is compulsorily and involuntarily converted within the meaning of section 1033(a), or

(4) A disposition of the residence pursuant to a settlement in a divorce or legal separation proceeding where the other spouse retains the residence as

principal residence (as defined in §1.44–5(a)).

[T.D. 7391, 40 FR 55854, Dec. 2, 1975; 40 FR 58138, Dec. 15, 1975]

§ 1.44–5 Definitions.

For purposes of section 44 and the regulations thereunder—

(a) *New principal residence.* The term ''new principal residence'' means a principal residence, the original use of which commences with the taxpayer. The term ''principal residence'' has the same meaning as under section 1034 of the Code. For this purpose, the term ''residence'' includes, without being limited to, a single family structure, a residential unit in a condominium or cooperative housing project, a townhouse, and a factory-made home. In the case of a tenant-stockholder in a cooperative housing corporation references to property used by the taxpayer as his principal residence and references to the residence of a taxpayer shall include stock held by the tenant-stockholder in a cooperative housing project provided, however, that the taxpayer used as his principal residence the house or apartment which he was entitled as such stockholder to occupy. ''Original use'' of the new principal residence by the taxpayer means that such residence has never been used as a residence prior to its use as such by the taxpayer. For this purpose, a residence will qualify if the first occupancy was by the taxpayer pursuant to a lease arrangement pending settlement under a binding contract to purchase or pursuant to a lease arrangement where a written option to purchase the then existing residence was contained in the original lease agreement.

A renovated building does not qualify as new, regardless of the extent of the renovation nor does a condominium conversion qualify.

(b) *Purchase price*—(1) *General rule.* For purposes of section 44(a) and §1.44–1, the term ''purchase price'' means the adjusted basis of the new principal residence on the date of acquisition and includes all amounts attributable to the acquisition or construction, but only to the extent that such amounts constitute capital expenditures and are not allowable as deductions in computing taxable income. Such capital expenditures include but are not limited to the cost of acquisition or construction, title insurance, attorney's fees, transfer taxes, and other costs of transfer. For these purposes the adjusted basis of a factory-made home includes the cost of moving the home and setting it up as the taxpayer's principal residence only where such cost is included in the base price of the residence; it also includes the purchase price of the land on which the home is located, but only if such land was purchased by the taxpayer after March 12, 1975 and only if the taxpayer acquired the land prior to or in conjunction with the acquisition of such factory-made home. However, the adjusted basis does not include any expenditures involved in connection with the leasing of land on which the factory-made home is located. In the case of factory-made homes the adjusted basis includes furniture only where it is included in the base price of the unit.

(2) *Sale of old principal residence.* (i) The adjusted basis is reduced by any gain from the sale or involuntary conversion of an old principal residence, which is not recognized due to the application of section 1033 or section 1034. However, no reduction will be made for any gain excluded from tax by reason of the special treatment provided under the tax laws in the case of a sale by a taxpayer who has attained age 65 (section 121 of the code).

(ii) The rules in subdivision (i) of this subparagraph are illustrated by the following examples:

Example 1. A sells an old principal residence for $30,000 which has an adjusted basis of $20,000. A reinvests the proceeds by purchasing a new principal residence for $40,000 (including settlement costs which are capital in nature), and this purchase satisfies the statutory criteria under section 1034 for nonrecognition of gain. The credit under section 44 applies with respect to $30,000 ($40,000 costs minus $10,000 unrecognized gain) of the cost of the new principal residence.

Example 2. B and C, two sisters, purchase a new principal residence as joint tenants with the right of survivorship for a total purchase price of $40,000. B has previously sold her old principal residence for $25,000 and a $10,000 gain on the sale has qualified for nonrecognition under section 1034. B contributes $25,000 and C contributes $15,000. The adjusted basis of the new principal residence is $30,000 representing the total purchase price of $40,000 less $10,000 representing unrecognized gain under section 1034. The total credit allowable, therefore, is $1,500. Since joint tenants are treated as equal owners and since allocation of the credit is made in proportion to the taxpayer's respective ownership interests in such residence B and C each will receive a credit of $750.

Example 3. Taxpayer D is 65 years old and sells his old principal residence for $20,000 excluding all gain under section 121. He then purchases a new principal residence for $30,000. D's adjusted basis in his new principal residence is $30,000, and he is allowed a credit of $1,500.

(3) *Tie-in sales.* In the case of a purchase of a new principal residence which is tied in to the transfer of other property by the seller to the purchaser, whether purportedly by sale or gift, the adjusted basis of the residence is reduced by the amount of the excess of the fair market value of such other property received over the amount, if any, purportedly paid for it by the purchaser of the residence. For example, if a taxpayer receives a new car with a fair market value of $2,500 upon the purchase of a condominium apartment for a total purchase price of $40,000 (including settlement costs which are capital in nature) his adjusted basis in the residence for computation of the credit is $37,500.

(4) *Basis of new principal residence.* The taxpayer's basis in his new principal residence is not in any way affected by the allowance of the credit.

(c) *Purchase*—(1) *General rule.* Except as provided in subparagraph (2) of this paragraph, the term ''purchase'' means any acquisition of property.

(2) *Exceptions.* (i) An acquisition does not qualify as a purchase for the purpose of this paragraph if the property is acquired from a person whose relationship to the person acquiring it would result in the disallowance of losses under section 267 or 707(b). Such persons include—

(A) The purchaser's spouse, ancestors and lineal descendants,

(B) Related corporations as provided under section 267(b)(2),

(C) Related trusts as provided under section 267(b), (4), (5), (6), and (7),

(D) Related charitable organizations as provided under section 267(b)(9), and

(E) Related partnerships as provided under section 707(b)(1).

For purposes of this subdivision the constructive ownership rules of section 267(c) shall apply except that paragraph (4) of section 267(c) shall be treated as providing that the family of an individual shall include only his spouse, ancestors, and lineal descendants.

(ii) An acquisition does not qualify as a purchase for the purpose of this paragraph if the basis of the property in the hands of the person acquiring such property is determined—

(A) In whole or in part by reference to the adjusted basis of such property in the hands of the person from whom acquired (e.g., a gift under section 1015), or

(B) Under section 1014(a) (relating to property acquired from a decedent).

(d) *Self-construction.* The term ''self-construction'' means the construction of a residence (other than a factory-made home) to the taxpayer's specifications on land already owned or leased by the taxpayer at the time of commencement of construction. Thus, where a taxpayer purchases land and either builds a residence himself or hires an architect and a contractor to build a residence on that land, the taxpayer has ''self-constructed'' the residence.

(e) *Factory-made home.* The term ''factory-made homes'' includes mobile homes, houseboats and prefabricated and modular homes.

(f) *Lowest offer.* The term ''lowest offer'' means the lowest price at which the residence was offered for sale after February 28, 1975.

[T.D. 7391, 40 FR 55855, Dec. 2, 1975]

§ 1.44B–1 Credit for employment of certain new employees.

(a) *In general*—(1) *Targeted jobs credit.* Under section 44B a taxpayer may elect to claim a credit for wages (as defined in section 51(c) paid or incurred to members of a targeted group (as defined in section 51(d)). Generally, to qualify for the credit, the wages must be paid or incurred to members of a targeted group first hired after September 26, 1978. However, wages paid of incurred to a vocational rehabilitation referral (as defined in section 51(d)(2)) hired before September 27, 1978, may qualify for the credit if a credit under section 44B (as in effect prior to enactment of the Revenue Act of 1978) was claimed for the individual by the taxpayer for a taxable year beginning before January 1, 1979. The amount of the credit shall be determined under section 51. Section 280C(b) (relating to the requirement that the deduction for wages be reduced by the amount of the credit) and the regulations thereunder will not apply to taxpayers who do not elect to claim the credit.

(2) *New jobs credit.* Under section 44B (as in effect prior to enactment of the Revenue Act of 1978) a taxpayer may elect to claim as a credit the amount determined under sections 51, 52, and 53 (as in effect prior to enactment of the Revenue Act of 1978). Section 280C(b) (relating to the requirement that the deduction for wages be reduced by the amount of the credit) and the regulations thereunder will not apply to taxpayers who do not elect to claim the credit.

(b) *Time and manner of making election.* The election to claim the targeted jobs credit and the new jobs credit is made by claiming the credit on an original return, or on an amended return, at any time before the expiration of the 3-year period beginning on the last date prescribed by law for filing the return for the taxable year (determined without regard to extensions). The election may be revoked within the above-described 3-year period by filing an amended return on which the credit is not claimed.

(c) *Election by partnership, electing small business corporation, and members of a controlled group.* In the case of a partnership, the election shall be made by the partnership. In the case of an electing small business corporation (as defined in section 1371(a)), the election shall be made by the corporation. In the case of a controlled group of corporations (within the meaning of section 52(a) and the regulations issued thereunder) not filing a consolidlated return under section 1501, the election shall be made by each member of the group. In the case of an affiliated group filing a consolidated return under section 1501, the election shall be made by the group.

(Secs. 44B, 381, and 7805 of the Internal Revenue Code of 1954 (92 Stat. 2834, 26 U.S.C. 44B; 91 Stat. 148, 26 U.S.C. 381(c)(26); 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7921, 48 FR 52904, Nov. 23, 1983]

RESEARCH CREDIT—FOR TAXABLE YEARS BEGINNING BEFORE JANUARY 1, 1990

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[T.D. 8930, 66 FR 295, Jan. 3, 2001]

§ 1.41–3A Base period research expense.

(a) *Number of years in base period.* The term ''base period'' generally means the 3 taxable years immediately preceding the year for which a credit is being determined (''determination year''). However, if the first taxable year of the taxpayer ending after June 30, 1981, ends in 1981 or 1982, then with respect to that taxable year the term ''base period'' means the immediately preceding taxable year. If the second taxable year of the taxpayer ending after June 30, 1981, ends in 1982 or 1983, then with respect to that taxable year the term ''base period'' means the 2 immediately preceding taxable years.

(b) *New taxpayers.* If, with respect to any determination year, the taxpayer has not been in existence for the number of preceding taxable years that are included under paragraph (a) of this section in the base period for that year, then for purposes of paragraph (c)(1) of this section (relating to the determination of average qualified research expenses during the base period), the taxpayer shall be treated as—

(1) Having been in existence for that number of additional 12-month taxable years that is necessary to complete the base period specified in paragraph (a) of this section, and

(2) Having had qualified research expenses of zero in each of those additional years.

(c) *Definition of base period research expenses.* For any determination year, the term ''base period research expenses'' means the greater of—

(1) The average qualified research expenses for taxable years during the base period, or

(2) Fifty percent of the qualified research expenses for the determination year.

(d) *Special rules for short taxable years*—(1) *Short determination year.* If the determination year for which a research credit is being taken is a short taxable year, the amount taken into account under paragraph (c)(1) of this section shall be modified by multiplying that amount by the number of months in the short taxable year and dividing the result by 12.

(2) *Short base period year.* For purposes of paragraph (c)(1) of this section, if a year in the base period is a short taxable year, the qualified research expenses paid or incurred in the short taxable year are deemed to be equal to the qualified research expenses actually paid or incurred in that year multiplied by 12 and divided by the number of months in that year.

(3) *Years overlapping the effective dates of section 41 (section 44F)*—(i) *Determination years.* If a determination year includes months before July 1981, the determination year is deemed to be a short taxable year including only the months after June 1981. Accordingly, paragraph (d)(1) of this section is applied for purposes of determining the base period expenses for such year. See section 221(d)(2) of the Economic Recovery Tax Act of 1981.

(ii) *Base period years.* No adjustment is required in the case of a base period year merely because it overlaps June 30, 1981.

(4) *Number of months in a short taxable year.* The number of months in a short taxable year is equal to the number of whole calendar months contained in the year plus fractions for any partially included months. The fraction for a partially included month is equal to the number of days in the month that are included in the short taxable year divided by the total number of days in that month. Thus, if a short taxable year begins on January 1, 1982, and ends on June 9, 1982, it consists of 5 and 9/30 months.

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

Example 1. X Corp., an accrual-method taxpayer using the calendar year as its taxable year, is organized and begins carrying on a trade or business during 1979 and subsequently incurs qualified research expenses as follows:

1979	$10x
1980	150x
1/1/81–6/30/81	90x
7/1/81–12/31/81	110x
1982	250x
1983	450x

(i) *Determination year 1981.* For determination year 1981, the base period consists of the immediately preceding taxable year, calendar year 1980. Because the determination year includes months before July 1981, paragraph (d)(3)(i) of this section requires that the determination year be treated as a short taxable year. Thus, for purposes of paragraph (c)(1) of this section, as modified by paragraph (d)(1) of this section, the average qualified research expenses for taxable years during the base period are $75x ($150x, the average qualified research expenses for the base period, multiplied by 6, the number of months in the determination year after June 30, 1981, and divided by 12). Because this amount is greater than the amount determined under paragraph (c)(2) of this section (50 percent of the determination year's qualified research expense of $110x, or $55x), the amount of base period research expenses is $75x. The credit for determination year 1981 is equal to 25 percent of the excess of $110x (the qualified research expenditures incurred during the determination year including only expenditures accrued on or after July 1, 1981, through the end of the determination year) over $75x (the base period research expenses).

(ii) *Determination year 1982.* For determination year 1982, the base period consists of the 2 immediately preceding taxable years, 1980 and 1981. The amount determined under paragraph (c)(1) of this section (the average qualified research expenses for taxable years during the base period) is $175x (($150x + $90x + $110x)/2). This amount is greater than the amount determined under paragraph (c)(2) of this section, (50 percent of $250x, or $125x). Accordingly, the amount of base period research expenses is $175x. The credit for determination year 1982 is equal to 25 percent of the excess of $250x (the qualified research expenses incurred during the determination year) over $175x (the base period research expenses).

(iii) *Determination year 1983.* For determination year 1983, the base period consists of the 3 immediately preceding taxable years 1980, 1981 and 1982. The amount determined under paragraph (c)(1) of this section (the average qualified research expenses for taxable years during the base period) is $200x (($150x + $200x + $250x)/3). The amount determined under paragraph (c)(2) of this section is $225x (50 percent of the $450x of qualified research expenses in 1983). Accordingly, the amount of base period research expenses is $225x. The credit for determination year 1983 is equal to 25 percent of the excess of $450x (the qualified research expenses incurred during the determination year) over $225x (the base period research expenses).

Example 2. Y, an accrual-basis corporation using the calendar year as its taxable year comes into existence and begins carrying on a trade or business on July 1, 1983. Y incurs qualified research expenses as follows:

7/1/83—12/31/83	$80x
1984	200x
1985	200x

(i) *Determination year 1983.* For determination year 1983, the base period consists of the 3 immediately preceding taxable years: 1980, 1981 and 1982. Although Y was not in existence during 1980, 1981 and 1982, Y is treated under paragraph (b) of this section as having been in existence during those years with qualified research expenses of zero. Thus, the amount determined under paragraph (c)(1) of this section (the average qualified research expenses for taxable years during the base period) is $0x (($0x + $0x + $0x)/3). The amount determined under paragraph (c)(2) of this section is $40x (50 percent of $80x). Accordingly, the amount of base period research expenses is $40x. The credit for determination year 1983 is equal to 25 percent of the excess of $80x (the qualified research expenses incurred during the determination year) over $40x (the base period research expenses).

(ii) *Determination year 1984.* For determination year 1984, the base period consists of the 3 immediately preceding taxable years: 1981, 1982, and 1983. Under paragraph (b) of this section, Y is treated as having been in existence during years 1981 and 1982 with qualified research expenses of zero. Because July 1 through December 31, 1983 is a short taxable year, paragraph (d)(2) of this section requires that the qualified research expenses for that year be adjusted to $160x for purposes of determining the average qualified research expenses during the base period. The $160x results from the actual qualified research expenses for that year ($80x) multiplied by 12 and divided by 6 (the number of months in the short taxable year). Accordingly, the amount determined under paragraph (c)(1) of this section (the average qualified research expenses for taxable years during the base period) is $53⅓x (($0x + $0x + $160x)/3). The amount determined under paragraph (c)(2) of this section is $100x (50 percent of $200x). The amount of base period research expenses is $100x. The credit for determination year 1984 is equal to 25 percent of the excess of $200x (the qualified research expenses incurred during the determination year) over $100x (the base period research expenses).

(iii) *Determination year 1985*. For determination year 1985, the base period consists of the 3 immediately preceding taxable years: 1982, 1983, and 1984. Pursuant to paragraph (b) of this section, Y is treated as having been in existence during 1982 with qualified research expenses of zero. Because July 1 through December 31, 1982, is a short taxable year, paragraph (d)(2) of this section requires that the qualified research expense for that year be adjusted to $160x for purposes of determining the average qualified research expenses for taxable years during the base period. This $160x is the actual qualified research expense for that year ($80x) multiplied by 12 and divided by 6 (the number of months in the short taxable year). Accordingly, the amount determined under paragraph (c)(1) of this section (the average qualified research expenses for taxable years during the base period) is $120x (($0x + $160x + $200x)/3). The amount determined under paragraph (c)(2) of this section is $100x (50 percent of $200x). The amount of base period research expenses is $120x. The credit for determination year 1985 is equal to 25 percent of the excess of $200x (the qualified research expenses incurred during the determination year) over $120x (the base period research expenses).

[T.D. 8251, 54 FR 21204, May 17, 1989. Redesignated by T.D. 8930, 66 FR 289, Jan. 3, 2001]

RULES FOR COMPUTING CREDIT FOR INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY

§ 1.45D–0 Table of contents.

This section lists the paragraphs contained in § 1.45D–1.

[T.D. 9560, 76 FR 75777, Dec. 5, 2011, as amended by T.D. 9600, 77 FR 59546, Sept. 28, 2012]

§ 1.45D–1 New markets tax credit.

(a) *Current year credit.* The current year general business credit under section 38(b)(13) includes the new markets tax credit under section 45D(a).

(b) *Allowance of credit*—(1) *In general.* A taxpayer holding a qualified equity investment on a credit allowance date which occurs during the taxable year may claim the new markets tax credit determined under section 45D(a) and this section for such taxable year in an amount equal to the applicable percentage of the amount paid to a qualified community development entity (CDE) for such investment at its original issue. *Qualified equity investment* is defined in paragraph (c) of this section. *Credit allowance date* is defined in paragraph (b)(2) of this section. *Applicable percentage* is defined in paragraph (b)(3) of this section. A *CDE* is a qualified community development entity as defined in section 45D(c). The amount paid at original issue is determined under paragraph (b)(4) of this section.

(2) *Credit allowance date.* The term *credit allowance date* means, with respect to any qualified equity investment—

(i) The date on which the investment is initially made; and

(ii) Each of the 6 anniversary dates of such date thereafter.

(3) *Applicable percentage.* The *applicable percentage* is 5 percent for the first 3 credit allowance dates and 6 percent for the other 4 credit allowance dates.

(4) *Amount paid at original issue.* The amount paid to the CDE for a qualified equity investment at its original issue consists of all amounts paid by the taxpayer to, or on behalf of, the CDE (including any underwriter's fees) to purchase the investment at its original issue.

(c) *Qualified equity investment*—(1) *In general.* The term *qualified equity investment* means any equity investment (as defined in paragraph (c)(2) of this section) in a CDE if—

(i) The investment is acquired by the taxpayer at its original issue (directly or through an underwriter) solely in exchange for cash;

(ii) Substantially all (as defined in paragraph (c)(5) of this section) of such cash is used by the CDE to make qualified low-income community investments (as defined in paragraph (d)(1) of this section); and

(iii) The investment is designated for purposes of section 45D and this section as a qualified equity investment or a non-real estate qualified equity investment (as defined in paragraph (c)(8) of this section) by the CDE on its books and records using any reasonable method.

(2) *Equity investment.* The term *equity investment* means any stock (other than nonqualified preferred stock as defined in section 351(g)(2)) in an entity that is a corporation for Federal tax purposes and any capital interest in an entity that is a partnership for Federal tax purposes. See §§ 301.7701–1 through 301.7701–3 of this chapter for rules governing when a business entity, such as a business trust or limited liability company, is classified as a corporation or a partnership for Federal tax purposes.

(3) *Equity investments made prior to allocation*—(i) *In general.* Except as provided in paragraph (c)(3)(ii) of this section, an equity investment in an entity is not eligible to be designated as a qualified equity investment if it is made before the entity enters into an allocation agreement with the Secretary. An *allocation agreement* is an agreement between the Secretary and a CDE relating to a new markets tax credit allocation under section 45D(f)(2).

(ii) *Exceptions.* Notwithstanding paragraph (c)(3)(i) of this section, an equity investment in an entity is eligible to be designated as a qualified equity investment or a non-real estate qualified equity investment under paragraph (c)(1)(iii) of this section if—

(A) *Allocation applications submitted by August 29, 2002.* (*1*) The equity investment is made on or after April 20, 2001;

(*2*) The designation of the equity investment as a qualified equity investment is made for a credit allocation received pursuant to an allocation application submitted to the Secretary no later than August 29, 2002; and

(*3*) The equity investment otherwise satisfies the requirements of section 45D and this section; or

(B) *Other allocation applications.* (*1*) The equity investment is made on or after the date the Secretary publishes a Notice of Allocation Availability (NOAA) in the FEDERAL REGISTER;

(*2*) The designation of the equity investment as a qualified equity investment is made for a credit allocation received pursuant to an allocation application submitted to the Secretary under that NOAA; and

(*3*) The equity investment otherwise satisfies the requirements of section 45D and this section.

(iii) *Failure to receive allocation.* For purposes of paragraph (c)(3)(ii)(A) of this section, if the entity in which the equity investment is made does not receive an allocation pursuant to an allocation application submitted no later than August 29, 2002, the equity investment will not be eligible to be designated as a qualified equity investment. For purposes of paragraph (c)(3)(ii)(B) of this section, if the entity in which the equity investment is made does not receive an allocation under the NOAA described in paragraph (c)(3)(ii)(B)(*1*) of this section, the equity investment will not be eligible to be designated as a qualified equity investment.

(iv) *Initial investment date.* If an equity investment is designated as a qualified equity investment in accordance with paragraph (c)(3)(ii) of this section, the investment is treated as initially made on the effective date of the allocation agreement between the CDE and the Secretary.

(4) *Limitations*—(i) *In general.* The term *qualified equity investment* does not include—

(A) Any equity investment issued by a CDE more than 5 years after the date the CDE enters into an allocation agreement (as defined in paragraph (c)(3)(i) of this section) with the Secretary; and

(B) Any equity investment by a CDE in another CDE, if the CDE making the investment has received an allocation under section 45D(f)(2).

(ii) *Allocation limitation.* The maximum amount of equity investments issued by a CDE that may be designated under paragraph (c)(1)(iii) of this section by the CDE may not exceed the portion of the limitation amount allocated to the CDE by the Secretary under section 45D(f)(2).

(5) *Substantially all*—(i) *In general.* Except as provided in paragraph (c)(5)(v) of this section, the term *substantially all* means at least 85 percent. The substantially-all requirement must be satisfied for each annual period in the 7-year credit period using either the direct-tracing calculation under paragraph (c)(5)(ii) of this section, or the safe harbor calculation under paragraph (c)(5)(iii) of this section. For the first annual period, the substantially-all requirement is treated as satisfied if either the direct-tracing calculation under paragraph (c)(5)(ii) of this section, or the safe-harbor calculation under paragraph (c)(5)(iii) of this section, is performed on a single testing date and the result of the calculation is at least 85 percent. For each annual period other than the first annual period, the substantially-all requirement is treated as satisfied if either the direct-tracing calculation under paragraph (c)(5)(ii) of this section, or the safe harbor calculation under paragraph (c)(5)(iii) of this section, is performed every six months and the average of the two calculations for the annual period is at least 85 percent. For example, the CDE may choose the same two testing dates for all qualified equity investments regardless of the date each qualified equity investment was initially made under paragraph (b)(2)(i) of this section, provided the testing dates are six months apart. The use of the direct-tracing calculation under paragraph (c)(5)(ii) of this section (or the safe harbor calculation under paragraph (c)(5)(iii) of this section) for an annual period does not preclude the use of the safe harbor calculation under paragraph (c)(5)(iii) of this section (or the direct-tracing calculation under paragraph (c)(5)(ii) of this section) for another annual period, provided that a CDE that switches to a direct-tracing calculation must substantiate that the taxpayer's investment is directly traceable to qualified low-income community investments from the time of the CDE's initial investment in a qualified low-income community investment. For purposes of this paragraph (c)(5)(i), the *7-year credit period* means the period of 7 years beginning on the date the qualified equity investment is initially made. See paragraph (c)(6) of this section for circumstances in which a CDE may treat more than one equity investment as a single qualified equity investment.

(ii) *Direct-tracing calculation.* The substantially-all requirement is satisfied if at least 85 percent of the taxpayer's investment is directly traceable to qualified low-income community investments as defined in paragraph (d)(1) of this section. The direct-tracing calculation is a fraction the numerator of which is the CDE's aggregate cost basis determined under section 1012 in all of the qualified low-income community investments that are directly traceable to the taxpayer's cash investment, and the denominator of which is the amount of the taxpayer's cash investment under paragraph (b)(4) of this section. For purposes of this paragraph (c)(5)(ii), cost basis includes the cost basis of any qualified low-income community investment that becomes worthless. *See* paragraph (d)(2) of this section for the treatment of amounts received by a CDE in payment of, or for, capital, equity or principal with respect to a qualified low-income community investment.

(iii) *Safe harbor calculation.* The substantially-all requirement is satisfied if at least 85 percent of the aggregate gross assets of the CDE are invested in qualified low-income community investments as defined in paragraph (d)(1) of this section. The safe harbor calculation is a fraction the numerator of which is the CDE's aggregate cost basis determined under section 1012 in all of its qualified low-income community investments, and the denominator of which is the CDE's aggregate cost basis determined under section 1012 in all of its assets. For purposes of this paragraph (c)(5)(iii), cost basis includes the cost basis of any qualified low-income community investment that becomes worthless. *See* paragraph (d)(2) of this section for the treatment of amounts received by a CDE in payment of, or for, capital, equity or principal with respect to a qualified low-income community investment.

(iv) *Time limit for making investments.* The taxpayer's cash investment received by a CDE is treated as invested in a qualified low-income community investment as defined in paragraph (d)(1) of this section only to the extent that the cash is so invested within the 12-month period beginning on the date the cash is paid by the taxpayer (directly or through an underwriter) to the CDE.

(v) *Reduced substantially-all percentage.* For purposes of the substantially-all requirement (including the direct-tracing calculation under paragraph (c)(5)(ii) of this section and the safe harbor calculation under paragraph (c)(5)(iii) of this section), 85 percent is reduced to 75 percent for the seventh year of the 7-year credit period (as defined in paragraph (c)(5)(i) of this section).

(vi) *Examples.* The following examples illustrate an application of this paragraph (c)(5):

Example 1. X is a partnership and a CDE that has received a $1 million new markets tax credit allocation from the Secretary. On September 1, 2004, X uses a line of credit from a bank to fund a $1 million loan to Y. The loan is a qualified low-income community investment under paragraph (d)(1) of this section. On September 5, 2004, A pays $1 million to acquire a capital interest in X. X uses the proceeds of A's equity investment to pay off the $1 million line of credit that was used to fund the loan to Y. X's aggregate gross assets consist of the $1 million loan to Y and $100,000 in other assets. A's equity investment in X does not satisfy the substantially-all requirement under paragraph (c)(5)(i) of this section using the direct-tracing calculation under paragraph (c)(5)(ii) of this section because the cash from A's equity investment is not used to make X's loan to Y. However, A's equity investment in X satisfies the substantially-all requirement using the safe harbor calculation under paragraph (c)(5)(iii) of this section because at least 85 percent of X's aggregate gross assets are invested in qualified low-income community investments.

Example 2. X is a partnership and a CDE that has received a new markets tax credit allocation from the Secretary. On August 1, 2004, A pays $100,000 for a capital interest in X. On August 5, 2004, X uses the proceeds of A's equity investment to make an equity investment in Y. X controls Y within the meaning of paragraph (d)(6)(ii)(B) of this section. For the annual period ending July 31, 2005, Y is a qualified active low-income community business (as defined in paragraph (d)(4) of this section). Thus, for that period, A's equity investment satisfies the substantially-all requirement under paragraph (c)(5)(i) of this section using the direct-tracing calculation under paragraph (c)(5)(ii) of this section. For the annual period ending July 31, 2006, Y no longer is a qualified active low-income community business. Thus, for that period, A's equity investment does not satisfy the substantially-all requirement using the direct-tracing calculation. However, during the entire annual period ending July 31, 2006, X's remaining assets are invested in qualified low-income community investments with an aggregate cost basis of $900,000. Consequently, for the annual period ending July 31, 2006, at least 85 percent of X's aggregate gross assets are invested in qualified low-income community investments. Thus, for the annual period ending July 31, 2006, A's equity investment satisfies the substantially-all requirement using the safe harbor calculation under paragraph (c)(5)(iii) of this section.

Example 3. X is a partnership and a CDE that has received a new markets tax credit allocation from the Secretary. On August 1, 2004, A and B each pay $100,000 for a capital interest in X. X does not treat A's and B's equity investments as one qualified equity investment under paragraph (c)(6) of this section. On September 1, 2004, X uses the proceeds of A's equity investment to make an equity investment in Y and X uses the proceeds of B's equity investment to make an equity investment in Z. X has no assets other than its investments in Y and Z. X controls Y and Z within the meaning of paragraph (d)(6)(ii)(B) of this section. For the annual period ending July 31, 2005, Y and Z are qualified active low-income community businesses (as defined in paragraph (d)(4) of this section). Thus, for the annual period ending July 31, 2005, A's and B's equity investments satisfy the substantially-all requirement under paragraph (c)(5)(i) of this section using either the direct-tracing calculation under paragraph (c)(5)(ii) of this section or the safe harbor calculation under paragraph (c)(5)(iii) of this section. For the annual period ending July 31, 2006, Y, but not Z, is a qualified active low-income community business. Thus, for the annual period ending July 31, 2006—

(1) X does not satisfy the substantially-all requirement using the safe harbor calculation under paragraph (c)(5)(iii) of this section;

(2) A's equity investment satisfies the substantially-all requirement using the direct-tracing calculation because A's equity investment is directly traceable to Y; and

(3) B's equity investment does not satisfy the substantially-all requirement because B's equity investment is traceable to Z.

Example 4. X is a partnership and a CDE that has received a new markets tax credit allocation from the Secretary. On November 1, 2004, A pays $100,000 for a capital interest in X. On December 1, 2004, B pays $100,000 for a capital interest in X. On December 31, 2004, X uses $85,000 from A's equity investment and $85,000 from B's equity investment to make a $170,000 equity investment in Y, a qualified active low-income community business (as defined in paragraph (d)(4) of this section). X has no assets other than its investment in Y. X determines whether A's and B's equity investments satisfy the substantially-all requirement under paragraph (c)(5)(i) of this section on December 31, 2004. The calculation for A's and B's equity investments is 85 percent using either the direct-tracing calculation under paragraph (c)(5)(ii) of this section or the safe harbor calculation under paragraph (c)(5)(iii) of this section. Therefore, for the annual periods ending October 31, 2005, and November 30, 2005, A's and B's equity investments, respectively, satisfy the substantially-all requirement under paragraph (c)(5)(i) of this section. For the subsequent annual period, X performs its calculations on December 31, 2005, and June 30, 2006. The average of the two calculations on December 31, 2005, and June 30, 2006, is 85 percent using either the direct-tracing calculation under paragraph (c)(5)(ii) of this section or the safe harbor calculation under paragraph (c)(5)(iii) of this section. Therefore, for the annual periods ending October 31, 2006, and November 30, 2006, A's and B's equity investments, respectively, satisfy the substantially-all requirement under paragraph (c)(5)(i) of this section.

(6) *Aggregation of equity investments.* A CDE may treat any qualified equity investments issued on the same day as one qualified equity investment. If a CDE aggregates equity investments under this paragraph (c)(6), the rules in this section shall be construed in a manner consistent with that treatment.

(7) *Subsequent purchasers.* A qualified equity investment includes any equity investment that would (but for paragraph (c)(1)(i) of this section) be a qualified equity investment in the hands of the taxpayer if the investment was a qualified equity investment in the hands of a prior holder.

(8) *Non-real estate qualified equity investment.* If a qualified equity investment is designated as a non-real estate qualified equity investment under paragraph (c)(1)(iii) of this section, then the qualified equity investment may only satisfy the *substantially-all* requirement under paragraph (c)(5) of this section if the CDE makes qualified low-income community investments that are directly traceable (including investments made through one or more CDEs) to non-real estate qualified active low-income community businesses (as defined in paragraph (d)(10) of this section). The proceeds of a non-real estate qualified equity investment cannot be used for transactions involving a qualified active low-income community business that is not a non-real estate qualified active low-income community business.

(d) *Qualified low-income community investments*—(1) *In general.* The term *qualified low-income community investment* means any of the following:

(i) *Investment in a qualified active low-income community business or a non-real estate qualified active low-income community business.* Any capital or equity investment in, or loan to, any qualified active low-income community business (as defined in paragraph (d)(4) of this section) or any non-real estate qualified active low-income community business (as defined in paragraph (d)(10) of this section).

(ii) *Purchase of certain loans from CDEs*—(A) *In general.* The purchase by a CDE (the ultimate CDE) from another CDE (whether or not that CDE has received an allocation from the Secretary under section 45D(f)(2)) of any loan made by such entity that is a qualified low-income community investment. A loan purchased by the ultimate CDE from another CDE is a qualified low-income community investment if it qualifies as a qualified low-income community investment either—

(*1*) At the time the loan was made; or

(*2*) At the time the ultimate CDE purchases the loan.

(B) *Certain loans made before CDE certification.* For purposes of paragraph (d)(1)(ii)(A) of this section, a loan by an entity is treated as made by a CDE, notwithstanding that the entity was not a CDE at the time it made the loan, if the entity is a CDE at the time it sells the loan.

(C) *Intermediary CDEs.* For purposes of paragraph (d)(1)(ii)(A) of this section, the purchase of a loan by the ultimate CDE from a CDE that did not make the loan (the second CDE) is treated as a purchase of the loan by the ultimate CDE from the CDE that made the loan (the originating CDE) if—

(*1*) The second CDE purchased the loan from the originating CDE (or from another CDE); and

(*2*) Each entity that sold the loan was a CDE at the time it sold the loan.

(D) *Examples.* The following examples illustrate an application of this paragraph (d)(1)(ii):

Example 1. X is a partnership and a CDE that has received a new markets tax credit allocation from the Secretary. Y, a corporation, made a $500,000 loan to Z in 1999. In January of 2004, Y is certified as a CDE. On September 1, 2004, X purchases the loan from Y. At the time X purchases the loan, Z is a qualified active low-income community business under paragraph (d)(4)(i) of this section. Accordingly, the loan purchased by X from Y is a qualified low-income community investment under paragraphs (d)(1)(ii)(A) and (B) of this section.

Example 2. The facts are the same as in *Example 1* except that on February 1, 2004, Y sells the loan to W and on September 1, 2004, W sells the loan to X. W is a CDE. Under paragraph (d)(1)(ii)(C) of this section, X's purchase of the loan from W is treated as the purchase of the loan from Y. Accordingly, the loan purchased by X from W is a qualified low-income community investment under paragraphs (d)(1)(ii)(A) and (C) of this section.

Example 3. The facts are the same as in *Example 2* except that W is not a CDE. Because W was not a CDE at the time it sold the loan to X, the purchase of the loan by X from W is not a qualified low-income community investment under paragraphs (d)(1)(ii)(A) and (C) of this section.

(iii) *Financial counseling and other services.* Financial counseling and other services (as defined in paragraph (d)(7) of this section) provided to any qualified active low-income community business, or to any residents of a low-income community (as defined in section 45D(e)).

(iv) *Investments in other CDEs*—(A) *In general.* Any equity investment in, or loan to, any CDE (the second CDE) by a CDE (the primary CDE), but only to the extent that the second CDE uses the proceeds of the investment or loan—

(*1*) In a manner—

(*i*) That is described in paragraph (d)(1)(i) or (iii) of this section; and

(*ii*) That would constitute a qualified low-income community investment if it were made directly by the primary CDE;

(*2*) To make an equity investment in, or loan to, a third CDE that uses such proceeds in a manner described in paragraph (d)(1)(iv)(A)(*1*) of this section; or

(*3*) To make an equity investment in, or loan to, a third CDE that uses such proceeds to make an equity investment in, or loan to, a fourth CDE that uses such proceeds in a manner described in paragraph (d)(1)(iv)(A)(*1*) of this section.

(B) *Examples.* The following examples illustrate an application of paragraph (d)(1)(iv)(A) of this section:

Example 1. X is a partnership and a CDE that has received a new markets tax credit allocation from the Secretary. On September 1, 2004, X uses $975,000 to make an equity investment in Y. Y is a corporation and a CDE. On October 1, 2004, Y uses $950,000 from X's equity investment to make a loan to Z. Z is a qualified active low-income community business under paragraph (d)(4)(i) of this section. Of X's equity investment in Y, $950,000 is a qualified low-income community investment under paragraph (d)(1)(iv)(A)(*1*) of this section.

Example 2. W is a partnership and a CDE that has received a new markets tax credit allocation from the Secretary. On September 1, 2004, W uses $975,000 to make an equity investment in X. On October 1, 2004, X uses $950,000 from W's equity investment to make an equity investment in Y. X and Y are corporations and CDEs. On October 5, 2004, Y uses $925,000 from X's equity investment to make a loan to Z. Z is a qualified active low-income community business under paragraph (d)(4)(i) of this section. Of W's equity investment in X, $925,000 is a qualified low-income community investment under paragraph (d)(1)(iv)(A)(*2*) of this section because X uses proceeds of W's equity investment to make an equity investment in Y, which uses $925,000 of the proceeds in a manner described in paragraph (d)(1)(iv)(A)(*1*) of this section.

Example 3. U is a partnership and a CDE that has received a new markets tax credit allocation from the Secretary. On September 1, 2004, U uses $975,000 to make an equity investment in V. On October 1, 2004, V uses $950,000 from U's equity investment to make an equity investment in W. On October 5, 2004, W uses $925,000 from V's equity investment to make an equity investment in X. On November 1, 2004, X uses $900,000 from W's equity investment to make an equity investment in Y. V, W, X, and Y are corporations and CDEs. On November 5, 2004, Y uses $875,000 from X's equity investment to make a loan to Z. Z is a qualified active low-income community business under paragraph (d)(4)(i) of this section. U's equity investment in V is not a qualified low-income community investment because X does not use proceeds of W's equity investment in a manner described in paragraph (d)(1)(iv)(A)(*1*) of this section.

(2) *Payments of, or for, capital, equity or principal*—(i) *In general.* Except as otherwise provided in this paragraph (d)(2), amounts received by a CDE in payment of, or for, capital, equity or principal with respect to a qualified low-income community investment must be reinvested by the CDE in a qualified low-income community investment no later than 12 months from the date of receipt to be treated as continuously invested in a qualified low-income community investment. If the amounts received by the CDE are equal to or greater than the cost basis of the original qualified low-income community investment (or applicable portion thereof), and the CDE reinvests, in accordance with this paragraph (d)(2)(i), an amount at least equal to such original cost basis, then an amount equal to such original cost basis will be treated as continuously invested in a qualified low-income community investment. In addition, if the amounts received by the CDE are equal to or greater than the cost basis of the original qualified low-income community investment (or applicable portion thereof), and the CDE reinvests, in accordance with this paragraph (d)(2)(i), an amount less than such original cost basis, then only the amount so reinvested will be treated as continuously invested in a qualified low-income community investment. If the amounts received by the CDE are less than the cost basis of the original qualified low-income community investment (or applicable portion thereof), and the CDE reinvests an amount in accordance with this paragraph (d)(2)(i), then the amount treated as continuously invested in a qualified low-income community investment will equal the excess (if any) of such original cost basis over the amounts received by the CDE that are not so reinvested. Amounts received by a CDE in payment of, or for, capital, equity or principal with respect to a qualified low-income community investment during the seventh year of the 7-year credit period (as defined in paragraph (c)(5)(i) of this section) do not have to be reinvested by the CDE in a qualified low-income community investment in order to be treated as continuously invested in a qualified low-income community investment.

(ii) *Subsequent reinvestments.* In applying paragraph (d)(2)(i) of this section to subsequent reinvestments, the original cost basis is reduced by the amount (if any) by which the original cost basis exceeds the amount determined to be continuously invested in a qualified low-income community investment.

(iii) *Special rule for loans.* Periodic amounts received during a calendar year as repayment of principal on a loan that is a qualified low-income community investment are treated as continuously invested in a qualified low-income community investment if the amounts are reinvested in another qualified low-income community investment by the end of the following calendar year.

(iv) *Example.* The application of paragraphs (d)(2)(i) and (ii) of this section is illustrated by the following example:

Example. On April 1, 2003, A, B, and C each pay $100,000 to acquire a capital interest in X, a partnership. X is a CDE that has received a new markets tax credit allocation from the Secretary. X treats the 3 partnership interests as one qualified equity investment under paragraph (c)(6) of this section. In August 2003, X uses the $300,000 to make a qualified low-income community investment under paragraph (d)(1) of this section. In August 2005, the qualified low-income community investment is redeemed for $250,000. In February 2006, X reinvests $230,000 of the $250,000 in a second qualified low-income community investment and uses the remaining $20,000 for operating expenses. Under paragraph (d)(2)(i) of this section, $280,000 of the proceeds of the qualified equity investment is treated as continuously invested in a qualified low-income community investment. In December 2008, X sells the second qualified low-income community investment and receives $400,000. In March 2009, X reinvests $320,000 of the $400,000 in a third qualified low-income community investment. Under paragraphs (d)(2)(i) and (ii) of this section, $280,000 of the proceeds of the qualified equity investment is treated as continuously invested in a qualified low-income community investment ($40,000 is treated as invested in another qualified low-income community investment in March 2009).

(3) *Special rule for reserves.* Reserves (not in excess of 5 percent of the taxpayer's cash investment under paragraph (b)(4) of this section) maintained by the CDE for loan losses or for additional investments in existing qualified low-income community investments are treated as invested in a qualified low-income community investment under paragraph (d)(1) of this section. Reserves include fees paid to third parties to protect against loss of all or a portion of the principal of, or interest on, a loan that is a qualified low-income community investment.

(4) *Qualified active low-income community business*—(i) *In general.* The term *qualified active low-income community business* means, with respect to any taxable year, a corporation (including a nonprofit corporation) or a partnership engaged in the active conduct of a qualified business (as defined in paragraph (d)(5) of this section), if the requirements of paragraphs (d)(4)(i)(A), (B), (C), (D), and (E) of this section are met (or in the case of an entity serving targeted populations, if the requirements of paragraphs (d)(4)(i)(D), (E), and (d)(9)(i) or (ii) of this section are met). Solely for purposes of this section, a nonprofit corporation will be deemed to be engaged in the active conduct of a trade or business if it is engaged in an activity that furthers its purpose as a nonprofit corporation.

(A) *Gross-income requirement.* At least 50 percent of the total gross income of such entity is derived from the active conduct of a qualified business (as defined in paragraph (d)(5) of this section) within any low-income community (as defined in section 45D(e)). An entity is deemed to satisfy this paragraph (d)(4)(i)(A) if the entity meets the requirements of either paragraph (d)(4)(i)(B) or (C) of this section, if ''50 percent'' is applied instead of *40 percent.* In addition, an entity may satisfy this paragraph (d)(4)(i)(A) based on all the facts and circumstances. See paragraph (d)(4)(iv) of this section for certain circumstances in which an entity will be treated as engaged in the active conduct of a trade or business. See paragraph (d)(9) of this section for rules relating to targeted populations.

(B) *Use of tangible property*—(*1*) *In general.* At least 40 percent of the use of the tangible property of such entity (whether owned or leased) is within any low-income community. This percentage is determined based on a fraction the numerator of which is the average value of the tangible property owned or leased by the entity and used by the entity during the taxable year in a low-income community and the denominator of which is the average value of the tangible property owned or leased by the entity and used by the entity during the taxable year. Property owned by the entity is valued at its cost basis as determined under section 1012. Property leased by the entity is valued at a reasonable amount established by the entity. See paragraph (d)(9) of this section for rules relating to targeted populations.

(*2*) *Example.* The application of paragraph (d)(4)(i)(B)(*1*) of this section is illustrated by the following example:

Example. X is a corporation engaged in the business of moving and hauling scrap metal. X operates its business from a building and an adjoining parking lot that X owns. The building and the parking lot are located in a low-income community (as defined in section 45D(e)). X's cost basis under section 1012 for the building and parking lot is $200,000. During the taxable year, X operates its business 10 hours a day, 6 days a week. X owns and uses 40 trucks in its business, which, on average, are used 6 hours a day outside a low-income community and 4 hours a day inside a low-income community (including time in the parking lot). The cost basis under section 1012 of each truck is $25,000. During nonbusiness hours, the trucks are parked in the lot. Only X's 10-hour business days are used in calculating the use of tangible property percentage under paragraph (d)(4)(i)(B)(*1*) of this section. Thus, the numerator of the tangible property calculation is $600,000 (4⁄10 of $1,000,000 (the $25,000 cost basis of each truck times 40 trucks) plus $200,000 (the cost basis of the building and parking lot)) and the denominator is $1,200,000 (the total cost basis of the trucks, building, and parking lot), resulting in 50 percent of the use of X's tangible property being within a low-income community. Consequently, X satisfies the 40 percent use of tangible property test under paragraph (d)(4)(i)(B)(*1*) of this section.

(C) *Services performed.* At least 40 percent of the services performed for such entity by its employees are performed in a low-income community. This percentage is determined based on a fraction the numerator of which is the total amount paid by the entity for employee services performed in a low-income community during the taxable year and the denominator of which is the total amount paid by the entity for employee services during the taxable year. If the entity has no employees, the entity is deemed to satisfy this paragraph (d)(4)(i)(C), and paragraph (d)(4)(i)(A) of this section, if the entity meets the requirement of paragraph (d)(4)(i)(B) of this section if ''85 percent'' is applied instead of *40 percent*. See paragraph (d)(9) of this section for rules relating to targeted populations.

(D) *Collectibles.* Less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to collectibles (as defined in section 408(m)(2)) other than collectibles that are held primarily for sale to customers in the ordinary course of business.

(E) *Nonqualified financial property*—(*1*) *In general.* Less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to *nonqualified financial property*. For purposes of the preceding sentence, the term *nonqualified financial property* means debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other similar property except that such term does not include—

(*i*) Reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less (because the definition of *nonqualified financial property* includes debt instruments with a term in excess of 18 months, banks, credit unions, and other financial institutions are generally excluded from the definition of a *qualified active low-income community business*); or

(*ii*) Debt instruments described in section 1221(a)(4).

(*2*) *Construction of real property.* For purposes of paragraph (d)(4)(i)(E)(*1*)(*i*) of this section, the proceeds of a capital or equity investment or loan by a CDE that will be expended for construction of real property within 12 months after the date the investment or loan is made are treated as a reasonable amount of working capital.

(ii) *Proprietorships.* Any business carried on by an individual as a proprietor is a qualified active low-income community business if the business would meet the requirements of paragraph (d)(4)(i) of this section if the business were incorporated.

(iii) *Portions of business*—(A) *In general.* A CDE may treat any trade or business (or portion thereof) as a qualified active low-income community business if the trade or business (or portion thereof) would meet the requirements of paragraph (d)(4)(i) of this section if the trade or business (or portion thereof) were separately incorporated and a complete and separate set of books and records is maintained for that trade or business (or portion thereof). However, the CDE's capital or equity investment or loan is not a qualified low-income community investment under paragraph (d)(1)(i) of this section to the extent the proceeds of the investment or loan are not used for the trade or business (or portion thereof) that is treated as a qualified active low-income community business under this paragraph (d)(4)(iii)(A).

(B) *Examples.* The following examples illustrate an application of paragraph (d)(4)(iii) of this section:

Example 1. X is a partnership and a CDE that receives a new markets tax credit allocation from the Secretary. A pays $1 million for a capital interest in X. Z is a corporation that operates a supermarket that is not in a low-income community (as defined in section 45D(e)). X uses the proceeds of A's equity investment to make a loan to Z that Z will use to construct a new supermarket in a low-income community. Z will maintain a complete and separate set of books and records for the new supermarket. The proceeds of X's loan to Z will be used exclusively for the new supermarket. Assume that Z's new supermarket in the low-income community would meet the requirements to be a qualified active low-income community business under paragraph (d)(4)(i) of this section if it were separately incorporated. Pursuant to paragraph (d)(4)(iii)(A) of this section, X treats Z's new supermarket as the qualified active low-income community business. Accordingly, X's loan to Z is a qualified low-income community investment under paragraph (d)(1)(i) of this section.

Example 2. X is a partnership and a CDE that receives a new markets tax credit allocation from the Secretary. A pays $1 million for a capital interest in X. Z is a corporation that operates a liquor store in a low-income community (as defined in section 45D(e)). A liquor store is not a qualified business under paragraph (d)(5)(iii)(B) of this section. X uses the proceeds of A's equity investment to make a loan to Z that Z will use to construct a restaurant next to the liquor store. Z will maintain a complete and separate set of books and records for the new restaurant. The proceeds of X's loan to Z will be used exclusively for the new restaurant. Assume that Z's restaurant would meet the requirements to be a qualified active low-income community business under paragraph (d)(4)(i) of this section if it were separately incorporated. Pursuant to paragraph (d)(4)(iii) of this section, X treats Z's restaurant as the qualified active low-income community business. Accordingly, X's loan to Z is a qualified low-income community investment under paragraph (d)(1)(i) of this section.

Example 3. X is a partnership and a CDE that receives a new markets tax credit allocation from the Secretary. A pays $1 million for a capital interest in X. Z is a corporation that operates an insurance company in a low-income community (as defined in section 45D(e)). Five percent or more of the average of the aggregate unadjusted bases of Z's property is attributable to nonqualified financial property under paragraph (d)(4)(i)(E) of this section. Z's insurance operations include different operating units including a claims processing unit. X uses the proceeds of A's equity investment to make a loan to Z for use in Z's claims processing operations. Z will maintain a complete and separate set of books and records for the claims processing unit. The proceeds of X's loan to Z will be used exclusively for the claims processing unit. Assume that Z's claims processing unit would meet the requirements to be a qualified active low-income community business under paragraph (d)(4)(i) of this section if it were separately incorporated. Pursuant to paragraph (d)(4)(iii) of this section, X treats Z's claims processing unit as the qualified active low-income community business. Accordingly, X's loan to Z is a qualified low-income community investment under paragraph (d)(1)(i) of this section.

(iv) *Active conduct of a trade or business*—(A) *Special rule.* For purposes of paragraph (d)(4)(i) of this section, an entity will be treated as engaged in the active conduct of a trade or business if, at the time the CDE makes a capital or equity investment in, or loan to, the entity, the CDE reasonably expects that the entity will generate revenues (or, in the case of a nonprofit corporation, engage in an activity that furthers its purpose as a nonprofit corporation) within 3 years after the date the investment or loan is made. This paragraph (d)(4)(iv) applies only for purposes of determining whether an entity is engaged in the active conduct of a trade or business and does not apply for purposes of determining whether the gross-income requirement under paragraph (d)(4)(i)(A), (d)(9)(i)(B)(*1*)(*i*), or (d)(9)(ii)(C)(*1*)(*i*) of this section is satisfied.

(B) *Example.* The application of paragraph (d)(4)(iv)(A) of this section is illustrated by the following example:

Example. X is a partnership and a CDE that receives a new markets tax credit allocation from the Secretary on July 1, 2004. X makes a ten-year loan to Y. Y is a newly formed entity that will own and operate a shopping center to be constructed in a low-income community. Y has no revenues but X reasonably expects that Y will generate revenues beginning in December 2005. Under paragraph (d)(4)(iv)(A) of this section, Y is treated as engaged in the active conduct of a trade or business for purposes of paragraph (d)(4)(i) of this section.

(5) *Qualified business*—(i) *In general.* Except as otherwise provided in this paragraph (d)(5), the term *qualified business* means any trade or business. There is no requirement that employees of a qualified business be residents of a low-income community.

(ii) *Rental of real property.* The rental to others of real property located in any low-income community (as defined in section 45D(e)) is a qualified business if and only if the property is not residential rental property (as defined in section 168(e)(2)(A)) and there are substantial improvements located on the real property. However, a CDE's investment in or loan to a business engaged in the rental of real property is not a qualified low-income community investment under paragraph (d)(1)(i) of this section to the extent a lessee of the real property is described in paragraph (d)(5)(iii)(B) of this section.

(iii) *Exclusions*—(A) *Trades or businesses involving intangibles.* The term *qualified business* does not include any trade or business consisting predominantly of the development or holding of intangibles for sale or license.

(B) *Certain other trades or businesses.* The term *qualified business* does not include any trade or business consisting of the operation of any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

(C) *Farming.* The term *qualified business* does not include any trade or business the principal activity of which is farming (within the meaning of section 2032A(e)(5)(A) or (B)) if, as of the close of the taxable year of the taxpayer conducting such trade or business, the sum of the aggregate unadjusted bases (or, if greater, the fair market value) of the assets owned by the taxpayer that are used in such a trade or business, and the aggregate value of the assets leased by the taxpayer that are used in such a trade or business, exceeds $500,000. For purposes of this paragraph (d)(5)(iii)(C), two or more trades or businesses will be treated as a single trade or business under rules similar to the rules of section 52(a) and (b).

(6) *Qualifications*—(i) *In general.* Except as provided in paragraph (d)(6)(ii) of this section, an entity is treated as a qualified active low-income community business for the duration of the CDE's investment in the entity if the CDE reasonably expects, at the time the CDE makes the capital or equity investment in, or loan to, the entity, that the entity will satisfy the requirements to be a qualified active low-income community business under paragraph (d)(4)(i) of this section throughout the entire period of the investment or loan.

(ii) *Control*—(A) *In general.* If a CDE controls or obtains control of an entity at any time during the 7-year credit period (as defined in paragraph (c)(5)(i) of this section), the entity will be treated as a qualified active low-income community business only if the entity satisfies the requirements of paragraph (d)(4)(i) of this section throughout the entire period the CDE controls the entity.

(B) *Definition of control.* Control means, with respect to an entity, direct or indirect ownership (based on value) or control (based on voting or management rights) of more than 50 percent of the entity. For purposes of the preceding sentence, the term *management rights* means the power to influence the management policies or investment decisions of the entity.

(C) *Disregard of control.* For purposes of paragraph (d)(6)(ii)(A) of this section, the acquisition of control of an entity by a CDE is disregarded during the 12-month period following such acquisition of control (the 12-month period) if—

(*1*) The CDE's capital or equity investment in, or loan to, the entity met the requirements of paragraph (d)(6)(i) of this section when initially made;

(*2*) The CDE's acquisition of control of the entity is due to financial difficulties of the entity that were unforeseen at the time the investment or loan described in paragraph (d)(6)(ii)(C)(*1*) of this section was made; and

(*3*) If the acquisition of control occurs before the seventh year of the 7-year credit period (as defined in paragraph (c)(5)(i) of this section), either—

(*i*) The entity satisfies the requirements of paragraph (d)(4) of this section by the end of the 12-month period; or

(*ii*) The CDE sells or causes to be redeemed the entire amount of the investment or loan described in paragraph (d)(6)(ii)(C)(*1*) of this section and, by the end of the 12-month period, reinvests the amount received in respect of the sale or redemption in a qualified low-income community investment under paragraph (d)(1) of this section.

For this purpose, the amount treated as continuously invested in a qualified low-income community investment is determined under paragraphs (d)(2)(i) and (ii) of this section.

(7) *Financial counseling and other services.* The term *financial counseling and other services* means advice provided by the CDE relating to the organization or operation of a trade or business.

(8) *Special rule for certain loans*—(i) *In general.* For purposes of paragraphs (d)(1)(i), (ii), and (iv) of this section, a loan is treated as made by a CDE to the extent the CDE purchases the loan from the originator (whether or not the originator is a CDE) within 30 days after the date the originator makes the loan if, at the time the loan is made, there is a legally enforceable written agreement between the originator and the CDE which—

(A) Requires the CDE to approve the making of the loan either directly or by imposing specific written loan underwriting criteria; and

(B) Requires the CDE to purchase the loan within 30 days after the date the loan is made.

(ii) *Example.* The application of paragraph (d)(8)(i) of this section is illustrated by the following example:

Example. (i) X is a partnership and a CDE that has received a new markets tax credit allocation from the Secretary. On October 1, 2004, Y enters into a legally enforceable written agreement with W. Y and W are corporations but only Y is a CDE. The agreement between Y and W provides that Y will purchase loans (or portions thereof) from W within 30 days after the date the loan is made by W, and that Y will approve the making of the loans.

(ii) On November 1, 2004, W makes an $825,000 loan to Z pursuant to the agreement between Y and W. Z is a qualified active low-income community business under paragraph (d)(4) of this section. On November 15, 2004, Y purchases the loan from W for $840,000. On December 31, 2004, X purchases the loan from Y for $850,000.

(iii) Under paragraph (d)(8)(i) of this section, the loan to Z is treated as made by Y. Y's loan to Z is a qualified low-income community investment under paragraph (d)(1)(i) of this section. Accordingly, under paragraph (d)(1)(ii)(A) of this section, X's purchase of the loan from Y is a qualified low-income community investment in the amount of $850,000.

(9) *Targeted populations.* For purposes of section 45D(e)(2), targeted populations that will be treated as a low-income community are individuals, or an identifiable group of individuals, including an Indian tribe, who are low-income persons as defined in paragraph (d)(9)(i) of this section or who are individuals who otherwise lack adequate access to loans or equity investments as defined in paragraph (d)(9)(ii) of this section.

(i) *Low-income persons*—(A) *Definition*—(*1*) *In general.* For purposes of section 45D(e)(2) and this paragraph (d)(9), an individual shall be considered to be low-income if the individual's family income, adjusted for family size, is not more than—

(*i*) For metropolitan areas, 80 percent of the area median family income; and

(*ii*) For non-metropolitan areas, the greater of 80 percent of the area median family income, or 80 percent of the statewide non-metropolitan area median family income.

(*2*) *Area median family income.* For purposes of paragraph (d)(9)(i)(A)(*1*) of this section, *area median family income* is determined in a manner consistent with the determinations of median family income under section 8 of the Housing Act of 1937, as amended. Taxpayers must use the annual estimates of median family income released by the Department of Housing and Urban Development (HUD) and may rely on those figures until 45 days after HUD releases a new list of income limits, or until HUD's effective date for the new list, whichever is later.

(*3*) *Individual's family income.* For purposes of paragraph (d)(9)(i)(A)(*1*) of this section, an individual's family income is determined using any one of the following three methods for measuring family income:

(*i*) Household income as measured by the U.S. Census Bureau,

(*ii*) Adjusted gross income under section 62 as reported on Internal Revenue Service Form 1040. Adjusted gross income must include the adjusted gross income of any member of the individual's family (as defined in section 267(c)(4)) if the family member resides with the individual regardless of whether the family member files a separate return, (*iii*) Household income determined under section 8 of the Housing Act of 1937, as amended.

(B) *Qualified active low-income community business requirements for low-income targeted populations*—(*1*) *In general.* An entity will not be treated as a qualified active low-income community business for low-income targeted populations unless—

(*i*) Except as provided in paragraph (d)(9)(i)(D)(*2*) of this section, at least 50 percent of the entity's total gross income for any taxable year is derived from sales, rentals, services, or other transactions with individuals who are low-income persons for purposes of section 45D(e)(2) and this paragraph (d)(9);

(*ii*) At least 40 percent of the entity's employees are individuals who are low-income persons for purposes of section 45D(e)(2) and this paragraph (d)(9); or

(*iii*) At least 50 percent of the entity is owned by individuals who are low-income persons for purposes of section 45D(e)(2) and this paragraph (d)(9).

(*2*) *Employee.* The determination of whether an employee is a low-income person must be made at the time the employee is hired. If the employee is a low-income person at the time of hire, that employee is considered a low-income person for purposes of section 45D(e)(2) and this paragraph (d)(9) throughout the time of employment, without regard to any increase in the employee's income after the time of hire.

(*3*) *Owner*. The determination of whether an owner is a low-income person must be made at the time the qualified low-income community investment is made, or at the time the ownership interest is acquired by the owner, whichever is later. If an owner is a low-income person at the time the qualified low-income community investment is made or at the time the ownership interest is acquired by the owner, whichever is later, that owner is considered a low-income person for purposes of section 45D(e)(2) and this paragraph (d)(9) throughout the time the ownership interest is held by that owner.

(*4*) *Derived from.* For purposes of paragraph (d)(9)(i)(B)(*1*)(*i*) of this section, the term *derived from* includes gross income derived from:

(*i*) Payments made directly by low-income persons to the entity; and

(*ii*) Money and the fair market value of property or services provided to the entity primarily for the benefit of low-income persons, but only if the persons providing the money, property, or services do not receive a direct benefit from the entity (for this purpose, a contribution that benefits the general public is not a direct benefit).

(*5*) *Fair market value of sales, rentals, services, or other transactions*. For purposes of paragraph (d)(9)(i)(B)(*1*)(*i*) of this section, an entity with gross income that is derived from sales, rentals, services, or other transactions with both non low-income persons and low-income persons may treat the gross income derived from the sales, rentals, services, or other transactions with low-income persons as including the full fair market value even if the low-income persons do not pay fair market value.

(C) *120-percent-income restriction*—(*1*) *In general*—(*i*) In no case will an entity be treated as a qualified active low-income community business under paragraph (d)(9)(i) of this section if the entity is located in a population census tract for which the median family income exceeds 120 percent of, in the case of a tract not located within a metropolitan area, the statewide median family income, or in the case of a tract located within a metropolitan area, the greater of statewide median family income or metropolitan area median family income (120-percent-income restriction).

(*ii*) The 120-percent-income restriction shall not apply to an entity located within a population census tract with a population of less than 2,000 if such tract is not located in a metropolitan area.

(*iii*) The 120-percent-income restriction shall not apply to an entity located within a population census tract with a population of less than 2,000 if such tract is located in a metropolitan area and more than 75 percent of the tract is zoned for commercial or industrial use. For this purpose, the 75 percent calculation should be made using the area of the population census tract. For purposes of this paragraph (d)(9)(i)(C)(*1*)(*iii*), property for which commercial or industrial use is a permissible zoning use will be treated as zoned for commercial or industrial use.

(*2*) *Population census tract location*—(*i*) For purposes of the 120-percent-income restriction, an entity will be considered to be located in a population census tract for which the median family income exceeds 120 percent of the applicable median family income under paragraph (d)(9)(i)(C)(*1*)(*i*) of this section (non-qualifying population census tract) if at least 50 percent of the total gross income of the entity is derived from the active conduct of a qualified business (as defined in paragraph (d)(5) of this section) within one or more non-qualifying population census tracts (non-qualifying gross income amount); at least 40 percent of the use of the tangible property of the entity (whether owned or leased) is within one or more non-qualifying population census tracts (non-qualifying tangible property usage); and at least 40 percent of the services performed for the entity by its employees are performed in one or more non-qualifying population census tracts (non-qualifying services performance).

(*ii*) The entity is considered to have the non-qualifying gross income amount if the entity has non-qualifying tangible property usage or non-qualifying services performance of at least 50 percent instead of 40 percent.

(*iii*) If the entity has no employees, the entity is considered to have the non-qualifying gross income amount and non-qualifying services performance if at least 85 percent of the use of the tangible property of the entity (whether owned or leased) is within one or more non-qualifying population census tracts.

(D) *Rental of real property for low-income targeted populations*—(*1*) *In general*. An entity that rents to others real property for low-income targeted populations and that otherwise satisfies the requirements to be a qualified business under paragraph (d)(5) of this section will be treated as located in a low-income community for purposes of paragraph (d)(5)(ii) of this section if at least 50 percent of the entity's total gross income is derived from rentals to individuals who are low-income persons for purposes of section 45D(e)(2) and this paragraph (d)(9) or rentals to a qualified active low-income community business that meets the requirements for low-income targeted populations under paragraphs (d)(9)(i)(B)(*1*)(*i*) or (*ii*) and (d)(9)(i)(B)(*2*) of this section.

(*2*) *Special rule for entities whose sole business is the rental to others of real property*. If an entity's sole business is the rental to others of real property under paragraph (d)(9)(i)(D)(*1*) of this section, then the gross income requirement in paragraph (d)(9)(i)(B)(*1*)(*i*) of this section will be considered satisfied if the entity is treated as being located in a low-income community under paragraph (d)(9)(i)(D)(*1*) of this section.

(ii) *Individuals who otherwise lack adequate access to loans or equity investments*—(A) *In general*. Paragraph (d)(9)(ii) of this section may be applied only with regard to qualified low-income community investments made under the increase in the new markets tax credit limitation pursuant to section 1400N(m)(2). Therefore, only CDEs with a significant mission of recovery and redevelopment of the Gulf Opportunity Zone (GO Zone) that receive an allocation from the increase described in section 1400N(m)(2) may make qualified low-income community investments from that allocation pursuant to the rules in paragraph (d)(9)(ii) of this section.

(B) *GO Zone Targeted Population*. For purposes of the targeted populations rules under section 45D(e)(2), an individual otherwise lacks adequate access to loans or equity investments only if the individual was displaced from his or her principal residence as a result of Hurricane Katrina or the individual lost his or her principal source of employment as a result of Hurricane Katrina (GO Zone Targeted Population). In order to meet this definition, the individual's principal residence or principal source of employment, as applicable, must have been located in a population census tract within the GO Zone that contains one or more areas designated by the Federal Emergency Management Agency (FEMA) as flooded, having sustained extensive damage, or having sustained catastrophic damage as a result of Hurricane Katrina.

(C) *Qualified active low-income community business requirements for the GO Zone Targeted Population*—(*1*) *In general.* An entity will not be treated as a qualified active low-income community business for the GO Zone Targeted Population unless—

(*i*) At least 50 percent of the entity's total gross income for any taxable year is derived from sales, rentals, services, or other transactions with the GO Zone Targeted Population, low-income persons as defined in paragraph (d)(9)(i) of this section, or some combination thereof;

(*ii*) At least 40 percent of the entity's employees consist of the GO Zone Targeted Population, low-income persons as defined in paragraph (d)(9)(i) of this section, or some combination thereof; or

(*iii*) At least 50 percent of the entity is owned by the GO Zone Targeted Population, low-income persons as defined in paragraph (d)(9)(i) of this section, or some combination thereof.

(*2*) *Location*—(*i*) *In general.* In order to be a qualified active low-income community business under paragraph (d)(9)(ii)(C) of this section, the entity must be located in a population census tract within the GO Zone that contains one or more areas designated by FEMA as flooded, having sustained extensive damage, or having sustained catastrophic damage as a result of Hurricane Katrina (qualifying population census tract).

(*ii*) *Determination*—For purposes of the preceding paragraph, an entity will be considered to be located in a qualifying population census tract if at least 50 percent of the total gross income of the entity is derived from the active conduct of a qualified business (as defined in paragraph (d)(5) of this section) within one or more qualifying population census tracts (gross income requirement); at least 40 percent of the use of the tangible property of the entity (whether owned or leased) is within one or more qualifying population census tracts (use of tangible property requirement); and at least 40 percent of the services performed for the entity by its employees are performed in one or more qualifying population census tracts (services performed requirement). The entity is deemed to satisfy the gross income requirement if the entity satisfies the use of tangible property requirement or the services performed requirement on the basis of at least 50 percent instead of 40 percent. If the entity has no employees, the entity is deemed to satisfy the services performed requirement and the gross income requirement if at least 85 percent of the use of the tangible property of the entity (whether owned or leased) is within one or more qualifying population census tracts.

(D) *200-percent-income restriction*—(*1*) *In general*—(*i*) In no case will an entity be treated as a qualified active low-income community business under paragraph (d)(9)(ii) of this section if the entity is located in a population census tract for which the median family income exceeds 200 percent of, in the case of a tract not located within a metropolitan area, the statewide median family income, or, in the case of a tract located within a metropolitan area, the greater of statewide median family income or metropolitan area median family income (200-percent-income restriction).

(*ii*) The 200-percent-income restriction shall not apply to an entity located within a population census tract with a population of less than 2,000 if such tract is not located in a metropolitan area.

(*iii*) The 200-percent-income restriction shall not apply to an entity located within a population census tract with a population of less than 2,000 if such tract is located in a metropolitan area and more than 75 percent of the tract is zoned for commercial or industrial use. For this purpose, the 75 percent calculation should be made using the area of the population census tract. For purposes of this paragraph (d)(9)(ii)(D)(*1*)(*iii*), property for which commercial or industrial use is a permissible zoning use will be treated as zoned for commercial or industrial use.

(*2*) *Population census tract location*—(*i*) For purposes of the 200-percent-income restriction, an entity will be considered to be located in a population census tract for which the median family income exceeds 200 percent of the applicable median family income under paragraph (d)(9)(ii)(D)(*1*)(*i*) of this section (non-qualifying population census tract) if—at least 50 percent of the total gross income of the entity is derived from the active conduct of a qualified business (as defined in paragraph (d)(5) of this section) within one or more non-qualifying population census tracts (non-qualifying gross income amount); at least 40 percent of the use of the tangible property of the entity (whether owned or leased) is within one or more non-qualifying population census tracts (non-qualifying tangible property usage); and at least 40 percent of the services performed for the entity by its employees are performed in one or more non-qualifying population census tracts (non-qualifying services performance).

(*ii*) The entity is considered to have the non-qualifying gross income amount if the entity has non-qualifying tangible property usage or non-qualifying services performance of at least 50 percent instead of 40 percent.

(*iii*) If the entity has no employees, the entity is considered to have the non-qualifying gross income amount and non-qualifying services performance if at least 85 percent of the use of the tangible property of the entity (whether owned or leased) is within one or more non-qualifying population census tracts.

(E) *Rental of real property for the GO Zone Targeted Population.* The rental to others of real property for the GO Zone Targeted Population that otherwise satisfies the requirements to be a qualified business under paragraph (d)(5) of this section will be treated as located in a low-income community for purposes of paragraph (d)(5)(ii) of this section if at least 50 percent of the entity's total gross income is derived from rentals to the GO Zone Targeted Population, rentals to low-income persons as defined in paragraph (d)(9)(i) of this section, or rentals to a qualified active low-income community business that meets the requirements for the GO Zone Targeted Population under paragraph (d)(9)(ii)(C)(*1*)(*i*) or (*ii*) of this section.

(10) *Non-real estate qualified active low-income community business*—(i) *Definition.* The term *non-real estate qualified active low-income community business* means any qualified active low-income community business (as defined in paragraph (d)(4) of this section) whose predominant business activity does not include the development (including construction of new facilities and rehabilitation/enhancement of existing facilities), management, or leasing of real estate. For purposes of the preceding sentence, predominant business activity means a business activity that generates more than 50 percent of the business' gross income. The purpose of the capital or equity investment in, or loan to, the non-real estate qualified active low-income community business must not be connected to the development (including construction of new facilities and rehabilitation/enhancement of existing facilities), management, or leasing of real estate.

(ii) *Payments of, or for, capital, equity or principal with respect to a non-real estate qualified active low-income community business*—(A) *In general.* For purposes of paragraph (d)(2)(i) of this section, a portion of the amounts received by a CDE in payment of, or for, capital, equity, or principal with respect to a non-real estate qualified active low-income community business after year one of the 7-year credit period (as defined by paragraph (c)(5)(i) of this section) may be reinvested by the CDE in a qualifying entity (as defined in paragraph (d)(10)(ii)(D)). Any portion that the CDE chooses to reinvest in a qualifying entity must be reinvested by the CDE no later than 30 days from the date of receipt to be treated as continuously invested in a qualified low-income community investment for purposes of paragraph (d)(2)(i) of this section. If the amount reinvested in a qualifying entity exceeds the maximum aggregate portion of the non-real estate qualified equity investment, then the excess will not be treated as invested in a qualified low-income community investment. The maximum aggregate portion of the non-real estate qualified equity investment that may be reinvested into a qualifying entity, which will be treated as continuously invested in a qualified low-income community investment, may not exceed the following percentages of the non-real estate qualified equity investment in the following years:

(*1*) 15 percent in Year 2 of the 7-year credit period.

(*2*) 30 percent in Year 3 of the 7-year credit period.

(*3*) 50 percent in Year 4 of the 7-year credit period.

(*4*) 85 percent in Year 5 and Year 6 of the 7-year credit period.

(B) *Seventh year of the 7-year credit period.* Amounts received by a CDE in payment of, or for, capital, equity, or principal with respect to a non-real estate qualified active low-income community business (as defined in paragraph (d)(10)(i) of this section) during the seventh year of the 7-year credit period do not have to be reinvested by the CDE in a qualified low-income community investment to be treated as continuously invested in a qualified low-income community investment.

(C) *Amounts received from qualifying entity.* Except for the seventh year of the 7-year credit period under paragraph (d)(10)(ii)(B) of this section, amounts received from a qualifying entity must be reinvested by the CDE no later than 30 days from the date of receipt to be treated as continuously invested in a qualified low-income community investment.

(D) *Definition of qualifying entity.* For purposes of paragraphs (d)(10)(ii) and (d)(10)(iii) of this section, a *qualifying entity* is—

(*1*) A certified community development financial institution (certified CDFI) that is a CDE under section 45D(c)(2)(B) (as defined by 12 CFR 1805.201), which is unrelated to the CDE making the investment in the certified CDFI within the meaning of section 267(b) or section 707(b)(1); or

(*2*) An entity designated by the Secretary by publication in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter).

(e) *Recapture*—(1) *In general.* If, at any time during the 7-year period beginning on the date of the original issue of a qualified equity investment in a CDE, there is a recapture event under paragraph (e)(2) of this section with respect to such investment, then the tax imposed by Chapter 1 of the Internal Revenue Code for the taxable year in which the recapture event occurs is increased by the credit recapture amount under section 45D(g)(2). A recapture event under paragraph (e)(2) of this section requires recapture of credits allowed to the taxpayer who purchased the equity investment from the CDE at its original issue and to all subsequent holders of that investment.

(2) *Recapture event.* There is a recapture event with respect to an equity investment in a CDE if—

(i) The entity ceases to be a CDE;

(ii) The proceeds of the investment cease to be used in a manner that satisfies the substantially-all requirement of paragraph (c)(1)(ii) of this section; or

(iii) The investment is redeemed or otherwise cashed out by the CDE.

(3) *Redemption*—(i) *Equity investment in a C corporation.* For purposes of paragraph (e)(2)(iii) of this section, an equity investment in a CDE that is treated as a C corporation for Federal tax purposes is redeemed when section 302(a) applies to amounts received by the equity holder. An equity investment is treated as cashed out when section 301(c)(2) or section 301(c)(3) applies to amounts received by the equity holder. An equity investment is not treated as cashed out when only section 301(c)(1) applies to amounts received by the equity holder.

(ii) *Equity investment in an S corporation.* For purposes of paragraph (e)(2)(iii) of this section, an equity investment in a CDE that is an S corporation is redeemed when section 302(a) applies to amounts received by the equity holder. An equity investment in an S corporation is treated as cashed out when a distribution to a shareholder described in section 1368(a) exceeds the accumulated adjustments account determined under §1.1368–2 and any accumulated earnings and profits of the S corporation.

(iii) *Capital interest in a partnership.* In the case of an equity investment that is a capital interest in a CDE that is a partnership for Federal tax purposes, a pro rata cash distribution by the CDE to its partners based on each partner's capital interest in the CDE during the taxable year will not be treated as a redemption for purposes of paragraph (e)(2)(iii) of this section if the distribution does not exceed the CDE's *operating income* for the taxable year. In addition, a non-pro rata *de minimis* cash distribution by a CDE to a partner or partners during the taxable year will not be treated as a redemption. A non-pro rata *de minimis* cash distribution may not exceed the lesser of 5 percent of the CDE's *operating income* for that taxable year or 10 percent of the partner's capital interest in the CDE. For purposes of this paragraph (e)(3)(iii), with respect to any taxable year, *operating income* is the sum of:

(A) The CDE's taxable income as determined under section 703, except that—

(*1*) The items described in section 703(a)(1) shall be aggregated with the non-separately stated tax items of the partnership; and

(*2*) Any gain resulting from the sale of a capital asset under section 1221(a) or section 1231 property shall not be included in taxable income;

(B) Deductions under section 165, but only to the extent the losses were realized from qualified low-income community investments under paragraph (d)(1) of this section;

(C) Deductions under sections 167 and 168, including the additional first-year depreciation under section 168(k);

(D) Start-up expenditures amortized under section 195; and

(E) Organizational expenses amortized under section 709.

(4) *Bankruptcy*. Bankruptcy of a CDE is not a recapture event.

(5) *Waiver of requirement or extension of time*—(i) *In general*. The Commissioner may waive a requirement or extend a deadline if such waiver or extension does not materially frustrate the purposes of section 45D and this section.

(ii) *Manner for requesting a waiver or extension*. A CDE that believes it has good cause for a waiver or an extension may request relief from the Commissioner in a ruling request. The request should set forth all the relevant facts and include a detailed explanation describing the event or events relating to the request for a waiver or an extension. For further information on the application procedure for a ruling, see Rev. Proc. 2005–1 (2005–1 I.R.B. 1) or its successor revenue procedure (see §601.601(d)(2) of this chapter).

(iii) *Terms and conditions*. The granting of a waiver or an extension to a CDE under this section may require adjustments of the CDE's requirements under section 45D and this section as may be appropriate.

(6) *Cure period*. If a qualified equity investment fails the substantially-all requirement under paragraph (c)(5)(i) of this section, the failure is not a recapture event under paragraph (e)(2)(ii) of this section if the CDE corrects the failure within 6 months after the date the CDE becomes aware (or reasonably should have become aware) of the failure. Only one correction is permitted for each qualified equity investment during the 7-year credit period under this paragraph (e)(6).

(7) *Example*. The application of this paragraph (e) is illustrated by the following example:

Example. In 2003, A and B acquire separate qualified equity investments in X, a partnership. X is a CDE that has received a new markets tax credit allocation from the Secretary. X uses the proceeds of A's qualified equity investment to make a qualified low-income community investment in Y, and X uses the proceeds of B's qualified equity investment to make a qualified low-income community investment in Z. Y and Z are not CDEs. X controls both Y and Z within the meaning of paragraph (d)(6)(ii)(B) of this section. In 2003, Y and Z are qualified active low-income community businesses. In 2007, Y, but not Z, is a qualified active low-income community business and X does not satisfy the substantially-all requirement using the safe harbor calculation under paragraph (c)(5)(iii) of this section. A's equity investment satisfies the substantially-all requirement of paragraph (c)(1)(ii) of this section using the direct-tracing calculation of paragraph (c)(5)(ii) of this section because A's equity investment is traceable to Y. However, B's equity investment fails the substantially-all requirement using the direct-tracing calculation because B's equity investment is traceable to Z. Therefore, under paragraph (e)(2)(ii) of this section, there is a recapture event for B's equity investment (but not A's equity investment).

(f) *Basis reduction*—(1) *In general*. A taxpayer's basis in a qualified equity investment is reduced by the amount of any new markets tax credit determined under paragraph (b)(1) of this section with respect to the investment. A basis reduction occurs on each credit allowance date under paragraph (b)(2) of this section. This paragraph (f) does not apply for purposes of sections 1202, 1400B, and 1400F.

(2) *Adjustment in basis of interest in partnership or S corporation.* The adjusted basis of either a partner's interest in a partnership, or stock in an S corporation, must be appropriately adjusted to take into account adjustments made under paragraph (f)(1) of this section in the basis of a qualified equity investment held by the partnership or S corporation (as the case may be).

(g) *Other rules*—(1) *Anti-abuse.* If a principal purpose of a transaction or a series of transactions is to achieve a result that is inconsistent with the purposes of section 45D and this section, the Commissioner may treat the transaction or series of transactions as causing a recapture event under paragraph (e)(2) of this section.

(2) *Reporting requirements*—(i) *Notification by CDE to taxpayer*—(A) *Allowance of new markets tax credit.* A CDE must provide notice to any taxpayer who acquires a qualified equity investment in the CDE at its original issue that the equity investment is a qualified equity investment entitling the taxpayer to claim the new markets tax credit. The notice must be provided by the CDE to the taxpayer no later than 60 days after the date the taxpayer makes the investment in the CDE. The notice must contain the amount paid to the CDE for the qualified equity investment at its original issue and the taxpayer identification number of the CDE.

(B) *Recapture event.* If, at any time during the 7-year period beginning on the date of the original issue of a qualified equity investment in a CDE, there is a recapture event under paragraph (e)(2) of this section with respect to such investment, the CDE must provide notice to each holder, including all prior holders, of the investment that a recapture event has occurred. The notice must be provided by the CDE no later than 60 days after the date the CDE becomes aware of the recapture event.

(ii) *CDE reporting requirements to Secretary.* Each CDE must comply with such reporting requirements to the Secretary as the Secretary may prescribe.

(iii) *Manner of claiming new markets tax credit.* A taxpayer may claim the new markets tax credit for each applicable taxable year by completing Form 8874, ''New Markets Credit,'' and by filing Form 8874 with the taxpayer's Federal income tax return.

(iv) *Reporting recapture tax.* If there is a recapture event with respect to a taxpayer's equity investment in a CDE, the taxpayer must include the credit recapture amount under section 45D(g)(2) on the line for recapture taxes on the taxpayer's Federal income tax return for the taxable year in which the recapture event under paragraph (e)(2) of this section occurs (or on the line for total tax, if there is no such line for recapture taxes) and write *NMCR* (new markets credit recapture) next to the entry space.

(3) *Other Federal tax benefits*—(i) *In general.* Except as provided in paragraph (g)(3)(ii) of this section, the availability of Federal tax benefits does not limit the availability of the new markets tax credit. Federal tax benefits that do not limit the availability of the new markets tax credit include, for example:

(A) The rehabilitation credit under section 47;

(B) All deductions under sections 167 and 168, including the additional first-year depreciation under section 168(k), and the expense deduction for certain depreciable property under section 179; and

(C) All tax benefits relating to certain designated areas such as empowerment zones and enterprise communities under sections 1391 through 1397D, the District of Columbia Enterprise Zone under sections 1400 through 1400B, renewal communities under sections 1400E through 1400J, and the New York Liberty Zone under section 1400L.

(ii) *Low-income housing credit.* If a CDE makes a capital or equity investment or a loan with respect to a qualified low-income building under section 42, the investment or loan is not a qualified low-income community investment under paragraph (d)(1) of this section to the extent the building's eligible basis under section 42(d) is financed by the proceeds of the investment or loan.

(4) *Bankruptcy of CDE.* The bankruptcy of a CDE does not preclude a taxpayer from continuing to claim the

new markets tax credit on the remaining credit allowance dates under paragraph (b)(2) of this section.

(h) *Effective/applicability dates*—(1) *In general*. Except as provided in paragraphs (h)(2), (h)(3), and (h)(4) of this section, this section applies on or after December 22, 2004, and may be applied by taxpayers before December 22, 2004. The provisions that apply before December 22, 2004, are contained in §1.45D–1T (see 26 CFR part 1 revised as of April 1, 2003, and April 1, 2004).

(2) *Exception*. Paragraph (d)(5)(ii) of this section as it relates to the restriction on lessees described in paragraph (d)(5)(iii)(B) of this section applies to qualified low-income community investments made on or after June 22, 2005.

(3) *Targeted populations*. The rules in paragraph (d)(9) of this section and the last sentence in paragraph (d)(4)(iv)(A) of this section apply to taxable years ending on or after December 5, 2011. A taxpayer may apply the rules in paragraph (d)(9) of this section to taxable years ending before December 5, 2011 for designations made by the Secretary after October 22, 2004.

(4) *Investments in non-real estate businesses*. Paragraphs (c)(8) and (d)(10) of this section apply to equity investments in CDEs made on or after September 28, 2012.

[T.D. 9171, 69 FR 77627, Dec. 28, 2004; 70 FR 4012, Jan. 28, 2005, as amended by T.D. 9560, 76 FR 75778, Dec. 5, 2011; T.D. 9600, 77 FR 59546, Sept. 28, 2012]

§ 1.45G–0 Table of contents for the railroad track maintenance credit rules.

This section lists the table of contents for §1.45G–1.

§1.45G–1 Railroad track maintenance credit.

(2) Taxable years ending before September 7, 2006.

(3) Special rules for returns filed prior to November 9, 2007.

(4) Taxable years beginning after December 31, 2011.

(5) Taxable years beginning before January 1, 2012.

[T.D. 9365, 72 FR 63815, Nov. 13, 2007, as amended by T.D. 9717, 80 FR 18098, Apr. 3, 2015]

§ 1.45G–1 Railroad track maintenance credit.

(a) *In general.* For purposes of section 38, the railroad track maintenance credit (RTMC) for qualified railroad track maintenance expenditures (QRTME) paid or incurred by an eligible taxpayer during the taxable year is determined under this section. A taxpayer claiming the RTMC must do so by filing Form 8900, ''Qualified Railroad Track Maintenance Credit,'' with its timely filed (including extensions) Federal income tax return for the taxable year the RTMC is claimed. Paragraph (b) of this section provides definitions of terms. Paragraph (c) of this section provides rules for computing the RTMC, including rules regarding limitations on the amount of the credit. Paragraph (d) of this section provides rules for assigning miles of railroad track. Paragraph (e) of this section contains rules for adjusting basis for the amount of the RTMC claimed by an eligible taxpayer. Paragraph (f) of this section contains rules for computing the amount of the RTMC in the case of a controlled group, and for the allocation of the group credit among members of the controlled group.

(b) *Definitions.* For purposes of section 45G and this section, the following definitions apply:

(1) *Class II railroad and Class III railroad* have the respective meanings given to these terms by the Surface Transportation Board (STB) without regard to the controlled group rules under section 45G(e)(2).

(2) *Eligible railroad track* is railroad track (as defined in paragraph (b)(9) of this section) located within the United States that is owned or leased by a Class II railroad or Class III railroad at the close of its taxable year. For purposes of section 45G and this section, a Class II railroad or Class III railroad owns railroad track if the railroad track is subject to the allowance for depreciation under section 167 by the Class II railroad or Class III railroad.

(3) *Eligible taxpayer* is—

(i) A Class II railroad or Class III railroad during the taxable year;

(ii) Any person that transports property using the rail facilities (as defined in paragraph (b)(6) of this section) of a Class II railroad or Class III railroad during the taxable year, but only is an eligible taxpayer with respect to the miles of eligible railroad track assigned to the person for that taxable year by that Class II railroad or Class III railroad under paragraph (d) of this section; or

(iii) Any person that furnishes railroad-related property (as defined in paragraph (b)(7) of this section) or railroad-related services (as defined in paragraph (b)(8) of this section), to a Class II railroad or Class III railroad during the taxable year, but only is an eligible taxpayer with respect to the miles of eligible railroad track assigned to the person for that taxable year by that Class II railroad or Class III railroad under paragraph (d) of this section.

(4) *Qualifying railroad structure* is property located within the United States that is described in the following STB property accounts in 49 CFR Part 1201, Subpart A:

(i) Property Account 3, Grading.

(ii) Property Account 4, Other right-of-way expenditures.

(iii) Property Account 5, Tunnels and subways.

(iv) Property Account 6, Bridges, trestles, and culverts.

(v) Property Account 7, Elevated structures.

(vi) Property Account 8, Ties.

(vii) Property Account 9, Rails and other track material.

(viii) Property Account 11, Ballast.

(ix) Property Account 13, Fences, snowsheds, and signs.

(x) Property Account 27, Signals and interlockers.

(xi) Property Account 39, Public improvements; construction.

(5) *Qualified railroad track maintenance expenditures (QRTME)* are expenditures for maintaining, repairing, and improving qualifying railroad

structure (as defined in paragraph (b)(4) of this section) that is owned or leased as of January 1, 2005, by a Class II railroad or Class III railroad. These expenditures may or may not be chargeable to a capital account.

(6) *Rail facilities* of a Class II railroad or Class III railroad are railroad yards, tracks, bridges, tunnels, wharves, docks, stations, and other related assets that are used in the transport of freight by a railroad and that are owned or leased by the Class II railroad or Class III railroad.

(7) *Railroad-related property* is property that is provided directly to, and is unique to, a railroad and that, in the hands of a Class II railroad or Class III railroad, is described in—

(i) The following STB property accounts in 49 CFR Part 1201, Subpart A:

(A) Property Account 3, Grading;

(B) Property Account 5, Tunnels and subways;

(C) Property Account 22, Storage warehouses; and

(ii) Asset classes 40.1 through 40.54 in the guidance issued by the Internal Revenue Service under section 168(i)(1) (for further guidance, for example, see Rev. Proc. 87–56 (1987–2 CB 674), and §601.601(d)(2)(ii)(*b*) of this chapter), except that any office building, any passenger train car, and any miscellaneous structure if such structure is not provided directly to, and is not unique to, a railroad are excluded from the definition of railroad-related property.

(8) *Railroad-related services* are services that are provided directly to, and are unique to, a railroad and that relate to railroad shipping, loading and unloading of railroad freight, or repairs of rail facilities (as defined in paragraph (b)(6) of this section) or railroad-related property (as defined in paragraph (b)(7) of this section). Examples of railroad-related services are the transport of freight by rail; the loading and unloading of freight transported by rail; railroad bridge services; railroad track construction; providing railroad track material or equipment; locomotive leasing or rental; maintenance of railroad's right-of-way (including vegetation control); piggyback trailer ramping; rail deramping services; and freight train cars repair services. Examples of services that are not railroad-related services are general business services, such as, accounting and bookkeeping, marketing, legal services; janitorial services; office building rental; banking services (including financing of railroad-related property); and purchasing of, or services performed on, property not described in paragraph (b)(7) of this section.

(9) Except as provided in paragraph (e)(2) of this section, *railroad track* is property described in STB property accounts 8 (ties), 9 (rails and other track material), and 11 (ballast) in 49 CFR part 1201, Subpart A. *Double track* is treated as multiple lines of railroad track, rather than as a single line of railroad track. Thus, one mile of single track is one mile, but one mile of double track is two miles.

(10) *Form 8900*. If Form 8900 is revised or renumbered, any reference in this section to that form shall be treated as a reference to the revised or renumbered form.

(11) *Examples*. The application of this paragraph (b) is illustrated by the following examples. In all examples, the taxpayers use a calendar taxable year, and are not members of a controlled group.

Example 1. A is a manufacturer that in 2006, transports its products by rail using the railroad tracks owned by B, a Class II railroad that owns 500 miles of railroad track within the United States on December 31, 2006. B properly assigns for purposes of section 45G 100 miles of eligible railroad track to A in 2006. A is an eligible taxpayer for 2006 with respect to the 100 miles of eligible railroad track.

Example 2. C is a bank that loans money to several Class III railroads. In 2006, C loans money to D, a Class III railroad, who in turn uses the loan proceeds to purchase track material. Because providing loans is not a service that is unique to a railroad, C is not providing railroad-related services and, thus, C is not an eligible taxpayer, even if D assigns miles of eligible railroad track to C for purposes of section 45G.

Example 3. E leases locomotives directly to Class I, Class II, and Class III railroads. In 2006, E leases locomotives to F, a Class II railroad that owns 200 miles of railroad track within the United States on December 31, 2006. F properly assigns for purposes of section 45G 200 miles of eligible railroad track to E. Because locomotives are property that is unique to a railroad, and E leases these locomotives directly to F in 2006, E is an eligible taxpayer for 2006 with respect to the 200 miles of eligible railroad track assigned to E by F.

Example 4. The facts are the same as in Example 3, except that E leases passenger trains, not locomotives, to F. Because passenger trains are not railroad-related property for purposes of section 45G, E is not an eligible taxpayer even if F assigns miles of eligible railroad track to E for purposes of section 45G.

(c) *Determination of amount of railroad track maintenance credit for the taxable year*—(1) *General amount.* Except as provided in paragraph (c)(2) of this section, for purposes of section 38, the RTMC determined under section 45G(a) for the taxable year is equal to 50 percent of the QRTME paid or incurred (as determined under paragraph (c)(3) of this section) by an eligible taxpayer during the taxable year.

(2) *Limitation on the credit*—(i) *Eligible taxpayer is a Class II railroad or Class III railroad.* If an eligible taxpayer is a Class II railroad or Class III railroad, the RTMC determined under paragraph (c)(1) of this section for the Class II railroad or Class III railroad for any taxable year must not exceed $3,500 multiplied by the sum of—

(A) The number of miles of eligible railroad track owned or leased by the Class II railroad or Class III railroad, reduced by the number of miles of eligible railroad track assigned under paragraph (d) of this section by the Class II railroad or Class III railroad to another eligible taxpayer for that taxable year; and

(B) The number of miles of eligible railroad track owned or leased by another Class II railroad or Class III railroad that are assigned under paragraph (d) of this section to the Class II railroad or Class III railroad for the taxable year.

(ii) *Eligible taxpayer is not a Class II railroad or Class III railroad.* If an eligible taxpayer is not a Class II railroad or Class III railroad, the RTMC determined under paragraph (c)(1) of this section for the eligible taxpayer for any taxable year must not exceed $3,500 multiplied by the number of miles of eligible railroad track assigned under paragraph (d) of this section by a Class II railroad or Class III railroad to the eligible taxpayer for the taxable year.

(iii) *No carryover of amount that exceeds limitation.* Amounts that exceed the limitation under paragraph (c)(2)(i) of this section or paragraph (c)(2)(ii) of this section, may never be carried over to another taxable year.

(3) *Determination of amount of QRTME paid or incurred*—(i) *In general.* The term *paid or incurred* means, in the case of a taxpayer using an accrual method of accounting, a liability incurred (within the meaning of §1.446–1(c)(1)(ii)). A liability may not be taken into account under section 45G and this section prior to the taxable year during which the liability is incurred. Any amount that an eligible taxpayer (assignee) pays a Class II railroad or Class III railroad (assignor) in exchange for an assignment of one or more miles of eligible railroad track under paragraph (d) of this section, is treated, for purposes of this section, as QRTME paid or incurred by the assignee, and not by the assignor, at the time and to the extent the assignor pays or incurs QRTME.

(ii) *Effect of reimbursements received from persons other than a Class II or Class III railroad.* The amount of QRTME treated as paid or incurred during the taxable year by an eligible taxpayer under paragraphs (b)(3)(ii) and (iii) of this section shall be reduced by any amount to which the eligible taxpayer is entitled to be reimbursed, directly or indirectly, from persons other than a Class II or Class III railroad.

(4) *Examples.* The application of this paragraph (c) is illustrated by the following examples. In all examples, the taxpayers use an accrual method of accounting and a calendar taxable year, and are not members of a controlled group.

Example 1. Computation of RTMC; section 45G credit limitation is not exceeded. (i) G is a Class II railroad that owns or has leased to it 1,000 miles of railroad track within the United States on December 31, 2006. H is a manufacturer that in 2006, transports its products by rail using the rail facilities of G. In 2006, for purposes of section 45G, G assigns 100 miles of eligible railroad track to H and does not make any other assignments of railroad track miles. H did not receive any other assignments of railroad track miles in 2006. During 2006, G incurred QRTME in the amount of $2.5 million and H incurred QRTME in the amount of $200,000.

(ii) For 2006, G determines the tentative amount of RTMC under paragraph (c)(1) of this section to be $1,250,000 (50% multiplied by $2,500,000 QRTME incurred by G during 2006). G further determines G's credit limitation under paragraph (c)(2)(i) of this section for 2006 to be $3,150,000 ($3,500 multiplied by 900 miles of eligible railroad track (1,000 miles owned by, or leased to, G on December 31, 2006, less 100 miles assigned by G to H in 2006)). Because G's tentative amount of RTMC does not exceed G's credit limitation amount for 2006, G may claim a RTMC for 2006 in the amount of $1,250,000.

(iii) For 2006, H determines the tentative amount of RTMC under paragraph (c)(1) of this section to be $100,000 (50% multiplied by $200,000 QRTME incurred by H during 2006). H further determines H's credit limitation under paragraph (c)(2)(ii) of this section for 2006 to be $350,000 ($3,500 multiplied by 100 miles of eligible railroad track assigned by G to H in 2006). Because H's tentative amount of RTMC does not exceed H's credit limitation amount for 2006, H may claim a RTMC in the amount of $100,000.

Example 2. Computation of RTMC; section 45G credit limitation is exceeded. (i) The facts are the same as in *Example 1*, except that G assigned for purposes of section 45G only 50 miles of railroad track to H in 2006 and, during 2006, H incurred QRTME in the amount of $400,000.

(ii) For 2006, G determines the tentative amount of RTMC under paragraph (c)(1) of this section to be $1,250,000 (50% multiplied by $2,500,000 QRTME incurred by G during 2006). G further determines G's credit limitation under paragraph (c)(2)(i) of this section for 2006 to be $3,325,000 ($3,500 multiplied by 950 miles of eligible railroad track (1,000 miles owned by, or leased to, G on December 31, 2006, less 50 miles assigned by G to H in 2006)). Because G's tentative amount of RTMC does not exceed G's credit limitation amount for 2006, G may claim a RTMC in the amount of $1,250,000.

(iii) For 2006, H determines the tentative amount of RTMC under paragraph (c)(1) of this section to be $200,000 (50% multiplied by $400,000 QRTME incurred by H during 2006). H further determines H's credit limitation under paragraph (c)(2)(ii) of this section for 2006 to be $175,000 ($3,500 multiplied by 50 miles of eligible railroad track assigned by G to H in 2006). Because H's tentative amount of RTMC exceeds H's credit limitation amount for 2006, H may claim a RTMC in the amount of $175,000 (the credit limitation amount). Under paragraph (c)(2)(iii) of this section, there is no carryover of the $25,000 (the tentative amount of $200,000 less the credit limitation amount of $175,000) that exceeds the limitation.

Example 3. Railroad track miles assigned for payment. (i) J is a Class II railroad that owns or has leased to it 1,000 miles of railroad track within the United States on December 31, 2006. K is a corporation that sells ties, ballast, and other track material to Class I, Class II, and Class III railroads. During 2006, K sold these items to J and J incurred QRTME in the amount of $1 million. Also, on December 6, 2006, J assigned for purposes of section 45G 150 miles of eligible railroad track to K and K paid J $800,000 for that assignment. K did not pay or incur any other QRTME during 2006.

(ii) For 2006, in accordance with paragraph (c)(3)(ii) of this section, J is treated as having incurred QRTME in the amount of $200,000 ($1 million QRTME actually incurred by J less the $800,000 paid by K to J for the assignment of the railroad track miles in 2006). For 2006, J determines the tentative amount of RTMC under paragraph (c)(1) of this section to be $100,000 (50% multiplied by $200,000 QRTME treated as incurred by J during 2006). J further determines J's credit limitation amount under paragraph (c)(2)(i) of this section for 2006 to be $2,975,000 ($3,500 multiplied by 850 miles of eligible railroad track (1,000 miles owned by, or leased to, J on December 31, 2006, less 150 miles assigned by J to K in 2006)). Because J's tentative amount of RTMC does not exceed J's credit limitation amount for 2006, J may claim a RTMC in the amount of $100,000.

(iii) For 2006, K is an eligible taxpayer because, during 2006, K provided railroad-related property to J and received an assignment of eligible railroad track miles from J. Under paragraph (c)(3)(ii) of this section, K is treated as having incurred QRTME in the amount of $800,000 (the amount paid by K to J for the assignment of the railroad track miles in 2006). For 2006, K determines the tentative amount of RTMC under paragraph (c)(1) of this section to be $400,000 (50% multiplied by $800,000 QRTME treated as incurred by K during 2006). K further determines K's credit limitation amount under paragraph (c)(2)(ii) of this section for 2006 to be $525,000 ($3,500 multiplied by 150 miles of eligible railroad track assigned by J in 2006). Because K's tentative amount of RTMC does not exceed K's credit limitation amount for 2006, K may claim a RTMC in the amount of $400,000.

(iv) The results in this *Example 3* would be the same if K sold the ties, ballast, and other track material with a fair market value of $1 million to J for $200,000 in exchange for the assignment by J of 150 miles of eligible railroad track to K.

Example 4. Reimbursement of QRTME. (i) L is a Class III railroad that owns or has leased to it 500 miles of railroad track within the United States on December 31, 2006. M is a manufacturer that in 2006 transports its products by rail using the rail facilities of L. During 2006, L did not incur any QRTME. Also, in 2006, L assigned for purposes of section 45G 200 miles of eligible railroad track to M and agreed to reduce L's freight shipping rates to M by $250,000 in exchange for M upgrading these railroad track miles. Consequently, during 2006, M incurred QRTME of $500,000 to upgrade these 200 miles of railroad track and L reduced L's freight shipping rates for M by $250,000.

(ii) For 2006, M is an eligible taxpayer because, during 2006, M transported property using the rail facilities of L and received an assignment of eligible railroad track miles from L. The amount of QRTME paid or incurred by M during 2006 is $500,000 and is not reduced by the reimbursement of $250,000 by L to M because, under paragraph (c)(3)(ii) of this section, QRTME is not reduced by reimbursements from Class II or Class III railroads. For 2006, M determines the tentative amount of RTMC under paragraph (c)(1) of this section to be $250,000 (50% multiplied by $500,000 QRTME incurred by M during 2006). M further determines M's credit limitation amount under paragraph (c)(2)(ii) of this section for 2006 to be $700,000 ($3,500 multiplied by 200 miles of eligible railroad track assigned by L to M in 2006). Because M's tentative amount of RTMC does not exceed M's credit limitation amount for 2006, M may claim a RTMC in the amount of $250,000.

(d) *Assignment of track miles*—(1) *In general.* An assignment of any mile of eligible railroad track under this paragraph (d) is a designation by a Class II railroad or Class III railroad that is made solely for purposes of section 45G and this section of a specific number of miles of eligible railroad track as being assigned to another eligible taxpayer for a taxable year. A designation must be in writing and must include the name and taxpayer identification number of the assignee, and the information required under the rules of paragraph (d)(4)(iii)(B) of this section. A designation requires no transfer of legal title or other indicia of ownership of the eligible railroad track, and need not specify the location of any assigned mile of eligible railroad track. Further, an assigned mile of eligible railroad track need not correspond to any specific mile of eligible railroad track with respect to which the eligible taxpayer actually pays or incurs the QRTME.

(2) *Assignment eligibility.* Only a Class II railroad or Class III railroad may assign a mile of eligible railroad track. If a Class II railroad or Class III railroad assigns a mile of eligible railroad track to an eligible taxpayer, the assignee is not permitted to reassign any mile of eligible railroad track to another eligible taxpayer. The maximum number of miles of eligible railroad track that may be assigned by a Class II railroad or Class III railroad for any taxable year is its total miles of eligible railroad track less the miles of eligible railroad track that the Class II railroad or Class III railroad retains for itself in determining its RTMC for the taxable year.

(3) *Effective date of assignment.* If a Class II railroad or Class III railroad assigns a mile of eligible railroad track, the assignment is treated as being made by the Class II railroad or Class III railroad at the close of its taxable year in which the assignment was made. With respect to the assignee, the assignment of a mile of eligible railroad track is taken into account for the taxable year of the assignee that includes the date the assignment is treated as being made by the assignor Class II railroad or Class III railroad under this paragraph (d)(3).

(4) *Assignment information statement*—(i) *In general.* A taxpayer must file Form 8900, ''Qualified Railroad Track Maintenance Credit,'' with its timely filed (including extensions) Federal income tax return for the taxable year for which the taxpayer assigns any mile of eligible railroad track, even if the taxpayer is not itself claiming the RTMC for that taxable year.

(ii) *Assignor.* Except as provided in paragraph (d)(4)(iv) of this section, a Class II railroad or Class III railroad (assignor) that assigns one or more miles of eligible railroad track during a taxable year to one or more eligible taxpayers must attach to the assignor's Form 8900 for that taxable year an information statement providing—

(A) The name and taxpayer identification number of each assignee;

(B) The total number of miles of the assignor's eligible railroad track;

(C) The number of miles of eligible railroad track assigned by the assignor to each assignee for the taxable year; and

(D) The total number of miles of eligible railroad track assigned by the assignor to all assignees for the taxable year.

(iii) *Assignee.* Except as provided in paragraph (d)(4)(iv) of this section, an eligible taxpayer (assignee) that has received an assignment of miles of eligible railroad track during its taxable year from a Class II railroad or Class III railroad, and that claims the RTMC for that taxable year, must attach to the assignee's Form 8900 for that taxable year a statement—

(A) Providing the total number of miles of eligible railroad track assigned to the assignee for the assignee's taxable year; and

(B) Attesting that the assignee has in writing, and has retained as part of the assignee's records for purposes of §1.6001–1(a), the following information from each assignor:

(*1*) The name and taxpayer identification number of each assignor.

(*2*) The date of each assignment made by each assignor (as determined under paragraph (d)(3) of this section) to the assignee;

(*3*) The number of miles of eligible railroad track assigned by each assignor to the assignee for the assignee's taxable year.

(iv) *Special rules for returns filed prior to November 9, 2007.* If an eligible taxpayer's Federal income tax return for a taxable year beginning after December 31, 2004, and ending before November 9, 2007, was filed before December 13, 2007, and the eligible taxpayer is not filing an amended Federal income tax return for that taxable year pursuant to paragraph (g)(2) of this section before the eligible taxpayer's next filed original Federal income tax return, and the eligible taxpayer wants to apply paragraph (g)(2) of this section but did not include with that return the information specified in paragraph (d)(4)(ii) or (iii) of this section, as applicable, the eligible taxpayer must attach a statement containing the information specified in paragraph (d)(4)(ii) or (iii) of this section, as applicable, to either—

(A) The eligible taxpayer's next filed original Federal income tax return; or

(B) The eligible taxpayer's amended Federal income tax return that is filed pursuant to paragraph (g)(2) of this section, provided that amended Federal income tax return is filed by the eligible taxpayer before its next filed original Federal income tax return.

(5) *Special rules*—(i) *Effect of subsequent dispositions of eligible railroad track during the assignment year.* If a Class II railroad or Class III railroad assigns one or more miles of eligible railroad track that it owned or leased as of the actual date of the assignment, but does not own or lease any eligible railroad track at the close of the taxable year in which the assignment is made by the Class II railroad or Class III railroad, the assignment is not valid for that taxable year for purposes of section 45G and this section.

(ii) *Effect of multiple assignments of eligible railroad track miles during the same taxable year.* If a Class II railroad or Class III railroad assigns more miles of eligible railroad track than it owned or leased as of the close of the taxable year in which the assignment is made by the Class II railroad or Class III railroad, the assignment is valid for purposes of section 45G and this section only with respect to the name of the assignee and the number of miles listed by the assignor Class II railroad or Class III railroad on the statement required under paragraph (d)(4)(ii) of this section and only to the extent of the maximum miles of eligible railroad track that may be assigned by the assignor Class II railroad or Class III railroad as determined under paragraph (d)(2) of this section. If the total number of miles on this statement exceeds the maximum miles of eligible railroad track that may be assigned by the assignor Class II railroad or Class III railroad (as determined under paragraph (d)(2) of this section), the total number of miles on the statement shall be reduced by the excess amount of miles. This reduction is allocated among each assignee listed on the statement in proportion to the total number of miles listed on the statement for that assignee.

(6) *Examples.* The application of this paragraph (d) is illustrated by the following examples. In none of the examples are the taxpayers members of a controlled group:

Example 1. Assignor and assignee have the same taxable year. (i) N, a calendar year taxpayer, is a Class II railroad that owns 500 miles of railroad track within the United States on December 31, 2006. O, a calendar year taxpayer, is not a railroad, but is a taxpayer that provides railroad-related property to N during 2006. On November 7, 2006, N assigns for purposes of section 45G 300 miles of eligible railroad track to O. O receives no other assignment of eligible railroad track in 2006. O pays or incurs QRTME in the amount of $100,000 in November 2006, and $50,000 in February 2007. N and O each file Form 8900 with their timely filed Federal income tax returns for 2006 and attach the statement required by paragraph (d)(4)(ii) and (iii), respectively, of this section reporting the assignment of the 300 miles of eligible railroad track to O.

(ii) The assignment of the 300 miles of eligible railroad track made by N to O on November 7, 2006, is treated as made on December 31, 2006 (at the close of the N's taxable year). Consequently, the assignment is taken into account by O for O's taxable year ending on December 31, 2006. For 2006, O is an eligible taxpayer because, during 2006, O provides railroad-related property to N and receives an assignment of 300 eligible railroad track miles from N. For 2006, O determines the tentative amount of RTMC under paragraph (c)(1) of this section to be $50,000 (50% multiplied by $100,000 QRTME paid or incurred by O during 2006). O further determines the credit limitation amount under paragraph (c)(2)(i) of this section for 2006 to be $1,050,000 ($3,500 multiplied by 300 miles of eligible railroad track assigned by N to O on December 31, 2006). Because O's tentative amount of RTMC does not exceed O's credit limitation amount for 2006, O may claim a RMTC for 2006 in the amount of $50,000.

Example 2. Assignor and assignee have different taxable years. (i) The facts are the same as in *Example 1*, except that O's taxable year ends on March 31.

(ii) The assignment of the 300 miles of eligible railroad track made by N to O on November 7, 2006, is treated as made on December 31, 2006. As a result, the assignment is taken into account by O for O's taxable year ending on March 31, 2007. Thus, for the taxable year ending on March 31, 2007, O determines the tentative amount of RMTC under paragraph (c)(1) of this section to be $75,000 (50% multiplied by $150,000 QRTME incurred by O during its taxable year ending March 31, 2007). Because O's tentative amount of RTMC does not exceed O's credit limitation amount for the taxable year ending March 31, 2007, O may claim a RMTC for the taxable year ending March 31, 2007, in the amount of $75,000.

Example 3. Assignment location differs from QRTME location. (i) P, a calendar-year taxpayer, is a Class III railroad that owns or has leased to it 200 miles of railroad track within the United States on December 31, 2006. P owns 50 miles of this railroad track and leases 150 miles of this railroad track from Q, a Class I railroad. On February 8, 2006, P assigns for purposes of section 45G 50 miles of eligible railroad track to R. R is not a railroad, but is a taxpayer that ships products using the 50 miles of eligible railroad track owned by P, and R paid $100,000 in 2006 to P to enable P to upgrade these 50 miles of eligible railroad track. In March 2006, P also assigns for purposes of section 45G 150 miles of eligible railroad track to S. S is not a railroad, but is a taxpayer that provides railroad-related property to P, and S paid $400,000 to P to enable P to upgrade P's 200 miles of eligible railroad track. For 2006, P pays or incurs QRTME in the amount of $500,000 to upgrade the 150 miles of eligible railroad track that it leases from Q and pays or incurs no QRTME on the 50 miles of eligible railroad track that it owns. For 2006, P receives no other assignment of eligible railroad track miles and did not retain any eligible railroad track miles for itself. Also, R and S do not pay or incur any other amounts that would qualify as QRTME during 2006. P, R, and S each file Form 8900 with their timely filed Federal income tax returns for 2006 and attach the statement required by paragraph (d)(4) (ii) or (iii) of this section, whichever applies, reporting the assignment of eligible railroad track by P to R or S in 2006.

(ii) For 2006, in accordance with paragraph (c)(3)(ii) of this section, P is treated as having incurred QRTME in the amount of $0 ($500,000 QRTME actually incurred by P less the $100,000 paid by R to P for the assignment of the 50 miles of eligible railroad track and the $400,000 paid by S to P for the assignment of the 150 miles of eligible railroad track). Further, P assigned all of its eligible railroad track miles to R and S for 2006. Accordingly, for 2006, P may not claim any RTMC.

(iii) For 2006, R is an eligible taxpayer because, during 2006, R ships property using the rail facilities of P and receives an assignment of 50 eligible railroad track miles from P. In accordance with paragraph (c)(3)(ii) of this section, R is treated as having incurred QRTME in the amount of $100,000 (the amount paid by R to P for the assignment of the eligible railroad track miles in 2006) even though no work was performed on the 50 miles of eligible railroad track that was assigned by P to R. For 2006, R determines the tentative amount of RTMC under paragraph (c)(1) of this section to be $50,000 (50% multiplied by $100,000 QRTME treated as incurred by R during 2006). R further determines the credit limitation amount under paragraph (c)(2)(ii) of this section to be $175,000 ($3,500 multiplied by 50 miles of eligible railroad track assigned by P to R in 2006). Because R's tentative amount of RTMC does not exceed R's credit limitation amount for 2006, R may claim a RTMC for 2006 in the amount of $50,000.

(iv) For 2006, S is an eligible taxpayer because, during 2006, S provides railroad-related property to P and receives an assignment of 150 eligible railroad track miles from P. In accordance with paragraph (c)(3)(ii) of this section, S is treated as having incurred QRTME in the amount of

$400,000 (amount paid by S to P for the assignment of the eligible railroad track miles in 2006). For 2006, S determines the tentative amount of RTMC under paragraph (c)(1) of this section to be $200,000 (50% multiplied by $400,000 QRTME treated as incurred by S during 2006). S further determines the credit limitation amount under paragraph (c)(2)(ii) of this section to be $525,000 ($3,500 multiplied by 150 miles of eligible railroad track assigned by P to S in 2006). Because S's tentative amount of RTMC does not exceed S's credit limitation amount for 2006, S may claim a RTMC for 2006 in the amount of $200,000.

Example 4. Multiple assignments of track miles. (i) T, a calendar-year taxpayer, is a Class III railroad that owns or has leased to it 200 miles of railroad track within the United States on December 31, 2006. T owns 75 miles of this railroad track and leases 125 miles of this railroad track from U, a Class I railroad. V and W are not railroads, but are both taxpayers that provide railroad-related services to T during 2006. On January 15, 2006, T assigns for purposes of section 45G 200 miles of eligible railroad track to V. V agrees to incur, in 2006, $1.4 million of QRTME to upgrade a portion of/segment of these 200 miles of eligible railroad track. Due to unexpected financial difficulties, V only incurs $250,000 of QRTME during 2006 and on May 15, 2006, T learns that V is unable to incur the remainder of the QRTME. On June 15, 2006, T assigns for purposes of section 45G the 200 miles of railroad track to W. In 2006, W incurs $1,100,000 of QRTME to upgrade a portion of/segment of the railroad track. For 2006, T receives no other assignment of eligible railroad track miles and did not retain any eligible railroad track miles for itself. V and W do not receive any other assignments of miles of eligible railroad track miles from a Class II railroad or Class III railroad during 2006. T and W each file Form 8900 with their timely filed Federal income tax returns for 2006, and attach the statement required by paragraph (d)(4) (ii) and (iii), respectively, of this section, reporting the assignment of 200 miles of eligible railroad track to W.

(ii) Because T did not retain any miles of eligible railroad track for itself for 2006, the maximum miles of eligible railroad track that may be assigned by T for 2006 is 200 miles pursuant to paragraph (d)(2) of this section. On the statement required by paragraph (d)(4)(ii) of this section, T assigned a total of 200 miles of eligible railroad track to W. Consequently, because T did not list V as an assignee on T's statement required by paragraph (d)(4)(ii) of this section, V did not receive an assignment of eligible railroad track miles from T during 2006 and V is not an eligible taxpayer for 2006. Thus, for 2006, V may not claim any RTMC even though V incurred QRTME in the amount of $250,000.

(iii) For 2006, W is an eligible taxpayer because, during 2006, W provides railroad-related services to T and receives an assignment of 200 eligible railroad track miles from T. W determines the tentative amount of RTMC under paragraph (c)(1) of this section to be $550,000 (50% multiplied by $1,100,000 QRTME incurred by W during 2006). W further determines the credit limitation amount under paragraph (c)(2)(ii) of this section to be $700,000 ($3,500 multiplied by the 200 miles of eligible railroad track assigned by T to W in 2006). Because W's tentative amount of RTMC does not exceed W's credit limitation amount for 2006, W may claim a RTMC for 2006 in the amount of $550,000.

Example 5. Multiple assignments of track miles. (i) Same facts as in *Example 4*, except T, to its Form 8900 for 2006, attaches the statement required by paragraph (d)(4)(ii) of this section assigning 200 miles of eligible railroad track to W and 200 miles of eligible railroad track to V.

(ii) Because T did not retain any miles of eligible railroad track for itself for 2006, the maximum miles of eligible railroad track that may be assigned by T for 2006 is 200 miles pursuant to paragraph (d)(2) of this section. However, on the statement required by paragraph (d)(4)(ii) of this section, T assigned a total of 400 miles of eligible railroad track (200 miles to W and 200 miles to V). Consequently, the 400 miles of eligible railroad track on this statement must be reduced to the 200 maximum miles of eligible railroad track available for assignment for 2006. Because the statement reports 200 miles of eligible railroad track assigned to each W and V, the reduction of 200 miles (400 total miles of eligible railroad track on the statement less 200 maximum miles of eligible railroad track available for assignment) is allocated pro-rata between W and V and, therefore, 100 miles each to W and V. Thus, pursuant to paragraph (d)(5)(ii) of this section, the number of miles of eligible railroad track assigned by T to W and V for 2006 is 100 miles each.

(iii) For 2006, V is an eligible taxpayer because, during 2006, V provides railroad-related services to T and receives an assignment of 100 eligible railroad track miles from T. V determines the tentative amount of RTMC under paragraph (c)(1) of this section to be $125,000 (50% multiplied by $250,000 QRTME incurred by V during 2006). V further determines the credit limitation amount under paragraph (c)(2)(ii) of this section to be $350,000 ($3,500 multiplied by the 100 miles of eligible railroad track assigned by T to V in 2006). Because V's tentative amount of RTMC does not exceed W's credit limitation amount for 2006, V may claim a RTMC for 2006 in the amount of $125,000.

(iv) For 2006, W is an eligible taxpayer because, during 2006, W provides railroad-related services to T and receives an assignment of 100 eligible railroad track miles from T. W determines the tentative amount of RTMC under paragraph (c)(1) of this section to be $550,000 (50% multiplied by $1,100,000 QRTME incurred by W during 2006). W further determines the credit limitation amount under paragraph (c)(2)(ii) of this section to be $350,000 ($3,500 multiplied by the 100 miles of eligible railroad track assigned by T to W in 2006). Because W's tentative amount of RTMC exceeds W's credit limitation amount for 2006, W may claim a RTMC for 2006 in the amount of $350,000 (the credit limitation). There is no carryover of the amount of $200,000 (the tentative amount of $550,000 less the credit limitation amount of $350,000).

(e) *Adjustments to basis*—(1) *In general*. All or some of the QRTME paid or incurred by an eligible taxpayer during the taxable year may be required to be capitalized under section 263(a) as a tangible asset or as an intangible asset. See, for example, §1.263(a)–4(d)(8), which requires capitalization of amounts paid or incurred by a taxpayer to produce or improve real property owned by another (except to the extent the taxpayer is selling services at fair market value to produce or improve the real property) if the real property can reasonably be expected to produce significant economic benefits for the taxpayer. The basis of the tangible asset or intangible asset includes the capitalized amount of the QRTME.

(2) *Basis adjustment made to railroad track*. An eligible taxpayer must reduce the adjusted basis of any railroad track with respect to which the eligible taxpayer claims the RTMC. For purposes of section 45G(e)(3) and this paragraph (e)(2), the adjusted basis of any railroad track with respect to which the eligible taxpayer claims the RTMC is limited to the amount of QRTME, if any, that is required to be capitalized into the qualifying railroad structure or an intangible asset. The adjusted basis of the railroad track is reduced by the amount of the RTMC allowable (as determined under paragraph (c) of this section) by the eligible taxpayer for the taxable year, but not below zero. This reduction is taken into account at the time the QRTME is paid or incurred by an eligible taxpayer and before the depreciation deduction with respect to such railroad track is determined for the taxable year for which the RTMC is allowable. If all or some of the QRTME paid or incurred by an eligible taxpayer during the taxable year is capitalized under section 263(a) to more than one asset, whether tangible or intangible (for example, railroad track and bridges), the reduction to the basis of these assets under this paragraph (e)(2) is allocated among each of the assets subject to the reduction in proportion to the unadjusted basis of each asset at the time the QRTME is paid or incurred during that taxable year.

(3) *Examples*. The application of this paragraph (e) is illustrated by the following examples. In each example, all taxpayers use a calendar taxable year, and no taxpayers are members of a controlled group.

Example 1. (i) X is a Class II railroad that owns 500 miles of railroad track within the United States on December 31, 2006. During 2006, X incurs $1 million of QRTME for maintaining this railroad track. X uses the track maintenance allowance method for track structure expenditures (for further guidance, see Rev. Proc. 2002–65 (2002–2 CB 700) and §601.601(d)(2)(ii)(*b*) of this chapter). Assume all of the $1 million QRTME is track structure expenditures and none of it was expended for new track structure.

(ii) For 2006, X determines the tentative amount of RTMC under paragraph (c)(1) of this section to be $500,000 (50% multiplied by $1 million QRTME incurred by X during 2006). X further determines the credit limitation amount under paragraph (c)(2)(i) of this section for 2006 to be $1,750,000 ($3,500 multiplied by 500 miles of eligible railroad track). Because X's tentative amount of RTMC does not exceed X's credit limitation amount for 2006, X may claim a RTMC for 2006 in the amount of $500,000.

(iii) Of the $1 million QRTME incurred by X during 2006, X determines under the track maintenance allowance method that $750,000 is the track maintenance allowance under section 162 and $250,000 is the capitalized amount for the track structure. In accordance with paragraph (e)(2) of this section, X reduces the capitalized amount of $250,000 by the RTMC of $500,000 claimed by X for 2006, but not below zero. Thus, the capitalized amount of $250,000 is reduced to zero. X also deducts under section 162 a track maintenance allowance of $750,000 on its 2006 Federal income tax return.

Example 2. (i) Y is a Class II railroad that owns or has leased to it 500 miles of eligible railroad track within the United States on

December 31, 2006. Z is not a railroad, but is a taxpayer that, in 2006, transports its products using the rail facilities of Y. In 2006, Y assigns for purposes of section 45G 300 miles of eligible railroad track to Z. Z does not receive any other assignments of eligible railroad track miles in 2006. During 2006, Z incurs QRTME in the amount of $1 million, and Y does not incur any QRTME. Y and Z each file Form 8900 with their timely filed Federal income tax returns for 2006 and attach the statement required by paragraph (d)(4)(ii) and (iii), respectively, of this section reporting the assignment of the 300 miles of eligible railroad track to Z.

(ii) For 2006, Z determines the tentative amount of RTMC under paragraph (c)(1) of this section to be $500,000 (50% multiplied by $1 million QRTME incurred by Z during 2006). Z further determines the credit limitation amount under paragraph (c)(2)(ii) of this section for 2006 to be $1,050,000 ($3,500 multiplied by 300 miles of eligible railroad track assigned by Y to Z in 2006). Because Z's tentative amount of RTMC does not exceed Z's credit limitation amount for 2006, Z may claim a RTMC for 2006 in the amount of $500,000.

(iii) For 2006, Z also must determine the portion of the $1 million QRTME that Z incurs that is required to be capitalized under section 263(a), and the portion that is a section 162 expense. Because Z is not a Class II railroad or Class III railroad, Z cannot use the track maintenance allowance method. Assume that all of the QRTME constitutes an intangible asset under §1.263(a)–4(d)(8) and, therefore, is required to be capitalized by Z under section 263(a) as an intangible asset. In accordance with paragraph (e)(2) of this section, Z reduces the capitalized amount of $1 million by the RTMC of $500,000 claimed by Z for 2006. Thus, the capitalized amount of $1 million for the intangible asset is reduced to $500,000. Further, pursuant to §1.167(a)–3(b)(1)(iv), Z may treat this intangible asset with an adjusted basis of $500,000 as having a useful life of 25 years for purposes of the depreciation allowance under section 167(a).

(f) *Controlled groups*—(1) *In general.* Pursuant to section 45G(e)(2), if an eligible taxpayer is a member of a controlled group of corporations, rules similar to the rules in §1.41–6T apply for determining the amount of the RTMC under section 45G(a) and this section. To determine the amount of RTMC (if any) allowable to a trade or business that at the end of its taxable year is a member of a controlled group, a taxpayer must—

(i) Compute the group credit in the manner described in paragraph (f)(3) of this section; and

(ii) Allocate the group credit among the members of the group in the manner described in paragraph (f)(4) of this section.

(2) *Definitions.* For purposes of section 45G(e)(2) and paragraph (f) of this section—

(i) A *trade or business* is a sole proprietorship, a partnership, a trust, an estate, or a corporation that is carrying on a trade or business (within the meaning of section 162). Any corporation that is a member of a commonly controlled group shall be deemed to be carrying on a trade or business if any other member of that group is carrying on any trade or business;

(ii) *Group* and *controlled group* means a controlled group of corporations, as defined in section 41(f)(5), or a group of trades or businesses under common control. For rules for determining whether trades or businesses are under common control, see §1.52–1(b) through (g);

(iii) *Group credit* means the RTMC (if any) allowable to a controlled group;

(iv) *Consolidated group* has the meaning set forth in §1.1502–1(h); and

(v) *Credit year* means the taxable year for which the member is computing the RTMC.

(3) *Computation of the group credit.* All members of a controlled group are treated as a single taxpayer for purposes of computing the RTMC. The group credit is computed by applying all of the section 45G computational rules (including the rules set forth in this section) on an aggregate basis.

(4) [Reserved]. For further guidance, see §1.45G–1T(f)(4).

(5) [Reserved]. For further guidance, see §1.45G–1T(f)(5).

(6) *Tax accounting periods used*—(i) *In general.* The credit allowable to a member of a controlled group is that member's share of the group credit computed as of the end of that member's taxable year. In computing the group credit for a group whose members have different taxable years, a member generally should treat the taxable year of another member that ends with or within the credit year of the computing member as the credit year of

that other member. For example, Q, R, and S are members of a controlled group of corporations. Both Q and R are calendar year taxpayers. S files a return using a fiscal year ending June 30. For purposes of computing the group credit at the end of Q's and R's taxable year on December 31, S's fiscal year ending June 30, which ends within Q's and R's taxable year, is treated as S's credit year.

(ii) *Special rule when timing of QRTME is manipulated.* If the timing of QRTME by members using different tax accounting periods is manipulated to generate a credit in excess of the amount that would be allowable if all members of the group used the same tax accounting period, then the appropriate Internal Revenue Service official in the operating division that has examination jurisdiction of the return may require each member of the group to calculate the credit in the current taxable year and all future years as if all members of the group had the same taxable year and base period as the computing member.

(7) *Membership during taxable year in more than one group.* A trade or business may be a member of only one group for a taxable year. If, without application of this paragraph (f)(7), a business would be a member of more than one group at the end of its taxable year, the business shall be treated as a member of the group in which it was included for its preceding taxable year. If the business was not included for its preceding taxable year in any group in which it could be included as of the end of its taxable year, the business shall designate in its timely filed (including extensions) federal income tax return for the taxable year the group in which it is being included. If the business does not so designate, then the appropriate Internal Revenue Service official in the operating division that has examination jurisdiction of the return will determine the group in which the business is to be included. If the Federal income tax return for a taxable year beginning after December 31, 2004, and ending before November 9, 2007, was filed before December 13, 2007, and the business wants to apply paragraph (g)(2) of this section but did not designate its group membership in that return, the business must designate its group membership for that year either—

(i) In its next filed original Federal income tax return; or

(ii) In its amended Federal income tax return that is filed pursuant to paragraph (g)(2) of this section, provided that amended Federal income tax return is filed by the business before its next filed original Federal income tax return.

(8) *Intra-group transactions*—(i) *In general.* Because all members of a group under common control are treated as a single taxpayer for purposes of determining the RTMC, transfers between members of the group are generally disregarded.

(ii) *Payment for QRTME.* Amounts paid or incurred by the owner (or lessor) of eligible railroad track to another member of the group for QRTME shall be taken into account as QRTME by the owner (or lessor) of the eligible railroad track for purposes of section 45G only to the extent of the lesser of—

(A) The amount paid or incurred to the other member; or

(B) The amount that would have been considered paid or incurred by the other member for the QRTME, if the QRTME was not reimbursed by the owner (or lessor) of the eligible railroad track.

(g) *Effective/applicability date*—(1) *In general.* Except as provided in paragraphs (g)(2) and (g)(3) of this section, this section applies to taxable years ending on or after September 7, 2006.

(2) *Taxable years ending before September 7, 2006.* A taxpayer may apply this section to taxable years beginning after December 31, 2004, and ending before September 7, 2006, provided that the taxpayer applies all provisions in this section to the taxable year.

(3) *Special rules for returns filed prior to November 9, 2007.* If a taxpayer's Federal income tax return for a taxable year beginning after December 31, 2004, and ending before November 9, 2007, was filed before December 13, 2007, and the taxpayer is not filing an amended Federal income tax return for that taxable year pursuant to paragraph (g)(2) of this section before the taxpayer's next filed original Federal income tax return, see paragraphs (d)(4)(iv) and

(f)(7) of this section for the statements that must be attached to the taxpayer's next filed original Federal income tax return.

(4) *Taxable years beginning after December 31, 2011*. [Reserved]. For further guidance, see §1.45G–1T(g)(4).

(5) *Taxable years beginning before January 1, 2012*. [Reserved]. For further guidance, see §1.45G–1T(g)(4).

[T.D. 9365, 72 FR 63816, Nov. 13, 2007, as amended by T.D. 9717, 80 FR 18098, Apr. 3, 2015; 80 FR 23238, Apr. 27, 2015]

EFFECTIVE DATE NOTE: At 83 FR 13185, Mar. 28, 2018, §1.45G–1 was amended by revising paragraphs (f)(4) and (5) and (g)(4) and (5), effective Apr. 2, 2018. For the convenience of the user, the revised text is set forth as follows:

§ 1.45G–1 Railroad track maintenance credit. * * * * *

(f) * * *

(4) *Allocation of the group credit*. The group credit is allocated to each member of the controlled group on a proportionate basis to its share of the aggregate of the QRTMEs taken into account for the taxable year by such controlled group for purposes of the credit.

(5) *Special rules for consolidated groups*—(i) *In general*. For purposes of applying paragraph (f)(4) of this section, members of a consolidated group who are members of a controlled group are treated as a single member of the controlled group.

(ii) *Special rule for allocation of group credit among consolidated group members*. The portion of the group credit that is allocated to a consolidated group is allocated to each member of the consolidated group on a proportionate basis to its share of the aggregate of the QRTMEs taken into account for the taxable year by such consolidated group for purposes of the credit.* * * * *

(g) * * *

(4) *Taxable years beginning after December 31, 2011*. Paragraphs (f)(4) and (5) and (g)(4) and (5) of this section apply to taxable years beginning on or after April 2, 2018. For taxable years ending before April 2, 2018, see §1.45G–1T as contained in 26 CFR part 1, as revised April 1, 2017.

(5) *Taxable years beginning before January 1, 2012*. See §1.45–1 as contained in 26 CFR part 1, revised April 1, 2014.

§ 1.45G–1T. Railroad track maintenance credit (temporary).

(a) through (e) [Reserved]. For further guidance, see §1.45G–1(a) through (e).

(f)(1) through (3) [Reserved]. For further guidance, see §1.45G–1(f)(1) through (3).

(4) *Allocation of the group credit*. The group credit is allocated to each member of the controlled group on a proportionate basis to its share of the aggregate of the QRTMEs taken into account for the taxable year by such controlled group for purposes of the credit.

(5) *Special rules for consolidated groups*—(i) *In general*. For purposes of applying paragraph (f)(4) of this section, members of a consolidated group who are members of a controlled group are treated as a single member of the controlled group.

(ii) *Special rule for allocation of group credit among consolidated group members*. The portion of the group credit that is allocated to a consolidated group is allocated to each member of the consolidated group on a proportionate basis to its share of the aggregate of the QRTMEs taken into account for the taxable year by such consolidated group for purposes of the credit.

(6) through (8) [Reserved]. For further guidance, see §1.45G–1(f)(6) through (8).

(g)(1) through (3) [Reserved]. For further guidance, see §1.45G–1(g)(1) through (3).

(4) *Taxable years beginning after December 31, 2011*. Section 1.45G–1T is applicable for taxable years beginning on or after April 3, 2015. Taxpayers may apply §1.45G–1T to taxable years beginning after December 31, 2011, but before April 3, 2015. For a taxpayer that does not apply §1.45G–1T to a taxable year beginning after December 31, 2011, but before April 3, 2015, the guidance that applies to such taxable year is contained in Notice 2013–20 (2013–15 IRB 902).

(5) *Taxable years ending before January 1, 2012*. See §1.45–1 as contained in 26 CFR part 1, revised April 1, 2014.

(6) *Expiration date*. The applicability of §1.45G–1T expires on April 2, 2018.

[T.D. 9717, 80 FR 18099, Apr. 3, 2015]

EFFECTIVE DATE NOTE: By T.D. 9832, 83 FR 13184, Mar. 28, 2018, §1.45G–1T was removed, effective Apr. 2, 2018.

§ 1.45R–0 Table of contents.

This section lists the table of contents for §§1.45R–1 through 1.45R–5.

[T.D. 9672, 79 FR 36646, June 30, 2014]

§ 1.45R–1 Definitions.

(a) *Definitions.* The definitions in this section apply to this section and §§ 1.45R–2, 1.45R–3, 1.45R–4, and 1.45R–5.

(1) *Average premium.* The term *average premium* means an average premium for the small group market in the rating area in which the employee enrolls for coverage. The average premium for the small group market in a rating area is determined by the Secretary of Health and Human Services.

(2) *Composite billing*. The term *composite billing* means a system of billing under which a health insurer charges a uniform premium for each of the employer's employees or charges a single aggregate premium for the group of covered employees that the employer then divides by the number of covered employees to determine the uniform premium.

(3) *Credit period*—(i) *In general*. The term *credit period* means, with respect to any eligible small employer (or any predecessor employer), the two-consecutive-taxable-year period beginning with the first taxable year beginning after 2013, for which the eligible small employer files an income tax return with an attached Form 8941, ''Credit for Small Employer Health Insurance Premiums'' (or files a Form 990–T, ''Exempt Organization Business Income Tax Return,'' with an attached Form 8941 in the case of a tax-exempt eligible employer). For a transition rule for 2014, see §1.45R–3(i).

(ii) *Examples*. The following examples illustrate the provisions of paragraph (a)(3)(i) of this section:

Example 1. (i) *Facts*. In 2014, an eligible small employer (Employer) that uses a calendar year as its taxable year begins to offer insurance through a SHOP Exchange. Employer has 4 employees and otherwise qualifies for the credit, but none of the employees enroll in the coverage offered by Employer through the SHOP Exchange. In mid-2015, the 4 employees enroll for coverage through the SHOP Exchange but Employer does not file Form 8941 or claim the credit. In 2016, Employer has 20 employees and all are enrolled in coverage offered through the SHOP Exchange. Employer files Form 8941 with Employer's 2016 tax return to claim the credit.

(ii) *Conclusion*. Employer's taxable year 2016 is the first year of the credit period. Accordingly, Employer's two-year credit period is 2016 and 2017.

Example 2. (i) *Facts*. Same facts as *Example 1*, but Employer files Form 8941 with Employer's 2015 tax return.

(ii) *Conclusion*. Employer's taxable year 2015 is the first year of the credit period. Accordingly, Employer's two-year credit period is 2015 and 2016 (and does not include 2017). Employer is entitled to a credit based on a partial year of SHOP Exchange coverage for Employer's taxable year 2015.

(4) *Eligible small employer*. (i) The term *eligible small employer* means an employer that meets the requirements set forth in §1.45R–2.

(ii) For the definition of tax-exempt eligible small employer, see paragraph (a)(19) of this section.

(iii) A farmers' cooperative described under section 521 that is subject to tax pursuant to section 1381, and otherwise meets the requirements of this paragraph (a)(4) and §1.45R–2, is an eligible small employer.

(5) *Employee*—(i) *In general*. Except as otherwise specifically provided in this paragraph (a)(5), the term *employee* means an individual who is an employee of the eligible small employer under the common law standard. See §31.3121(d)–1(c).

(ii) *Leased employees*. For purposes of this paragraph (a)(5), the term *employee* also includes a leased employee (as defined in section 414(n)).

(iii) *Certain individuals excluded*. The term *employee* does not include independent contractors (including sole proprietors), partners in a partnership, shareholders owning more than two percent of an S corporation, and any owners of more than five percent of other businesses. The term *employee* also does not include family members of these owners and partners, including the employee-spouse of a shareholder owning more than two percent of the stock of an S corporation, the employee-spouse of an owner of more than five percent of a business, the employee-spouse of a partner owning more than a five percent interest in a partnership, and the employee-spouse of a sole proprietor, or any other member of the household of these owners and partners who qualifies as a dependent under section 152(d)(2)(H).

(iv) *Seasonal workers*. The term *employee* does not include seasonal workers unless the seasonal worker provides services to the employer on more than 120 days during the taxable year.

(v) *Ministers*. Whether a minister is an employee is determined under the common law standard for determining worker status. If, under the common law standard, a minister is not an employee, the minister is not an employee for purposes of this paragraph (a)(5) and is not taken into account in determining an employer's FTEs, and premiums paid for the minister's health insurance coverage are not taken into account in computing the credit. If, under the common law standard, a minister is an employee, the minister is an employee for purposes of this paragraph (a)(5), and is taken into account in determining an employer's FTEs, and premiums paid by the employer for the minister's health insurance coverage can be taken into account in computing the credit. Because the performance of services by a minister in the exercise of his or her ministry is not treated as employment for purposes of the Federal Insurance Contributions Act (FICA), compensation paid to the minister is not wages as defined under section 3121(a), and is not counted as wages for purposes of computing an employer's average annual wages.

(vi) *Former employees.* Premiums paid on behalf of a former employee with no hours of service may be treated as paid on behalf of an employee for purposes of calculating the credit (see §1.45R–3) provided that, if so treated, the former employee is also treated as an employee for purposes of the uniform percentage requirement (see §1.45R–4). For the treatment of terminated employees for purposes of determining employer eligibility for the credit, see §1.45R–2(c).

(6) *Employer-computed composite rate.* The term *employer-computed composite rate* refers to a rate for a tier of coverage (such as employee-only, dependent or family) of a QHP that is the average rate determined by adding the premiums for that tier of coverage for all employees eligible to participate in the QHP (whether or not they actually receive coverage under the plan or under that tier of coverage) and dividing by the total number of such eligible employees. The employer-computed composite rate may be used in list billing to convert individual premiums for a tier of coverage into an employer-computed composite rate for that tier of coverage. See §1.45R–4(b)(3).

(7) *Exchange.* The term *Exchange* means an exchange as defined in 45 CFR 155.20.

(8) *Family member.* The term *family member* is defined with respect to a taxpayer as a child (or descendant of a child); a sibling or step-sibling; a parent (or ancestor of a parent); a step-parent; a niece or nephew; an aunt or uncle; or a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law or sister-in-law. A spouse of any of these family members is also considered a family member.

(9) *Full-time equivalent employee (FTE).* The number of *full-time equivalent employees (FTEs)* is determined by dividing the total number of hours of service for which wages were paid by the employer to employees during the taxable year by 2,080. See §1.45R–2(d) and (e) for permissible methods of calculating hours of service and the method for calculating the number of an employer's FTEs.

(10) *List billing.* The term *list billing* refers to a system of billing under which a health insurer lists a separate premium for each employee based on the age of the employee or other factors.

(11) *Net premium payments.* The term *net premium payments* means, in the case of an employer receiving a State tax credit or State subsidy for providing health insurance to its employees, the excess of the employer's actual premium payments over the State tax credit or State subsidy received by the employer. In the case of a State payment directly to an insurance company (or another entity licensed under State law to engage in the business of insurance), the employer's net premium payments are the employer's actual premium payments. If a State-administered program (such as Medicaid or another program that makes payments directly to a health care provider or insurance company on behalf of individuals and their families who meet certain eligibility guidelines) makes payments that are not contingent on the maintenance of an employer-provided group health plan, those payments are not taken into account in determining the employer's net premium payments.

(12) *Nonelective contribution.* The term *nonelective contribution* means an employer contribution other than a contribution pursuant to a salary reduction arrangement under section 125.

(13) *Payroll taxes.* For purposes of section 45R, the term *payroll taxes* means amounts required to be withheld as tax

from the employees of a tax-exempt eligible small employer under section 3402, amounts required to be withheld from such employees under section 3101(b), and amounts of tax imposed on the tax-exempt eligible small employer under section 3111(b).

(14) *Qualified health plan or QHP*. The term *qualified health plan* or the term *QHP* means a qualified health plan as defined in Affordable Care Act section 1301(a) (see 42 U.S.C. 18021(a)), but does not include a catastrophic plan described in Affordable Care Act section 1302(e) (see 42 U.S.C. 18022(e)).

(15) *Qualifying arrangement*. The term *qualifying arrangement* means an arrangement that requires an eligible small employer to make a nonelective contribution on behalf of each employee who enrolls in a QHP offered to employees by the employer through a SHOP Exchange in an amount equal to a uniform percentage (not less than 50 percent) of the premium cost of the QHP.

(16) *Seasonal worker*. The term *seasonal worker* means a worker who performs labor or services on a seasonal basis as defined by the Secretary of Labor, including (but not limited to) workers covered by 29 CFR 500.20(s)(1), and retail workers employed exclusively during holiday seasons. Employers may apply a reasonable, good faith interpretation of the term seasonal worker and a reasonable good faith interpretation of 29 CFR 500.20(s)(1) (including as applied by analogy to workers and employment positions not otherwise covered under 29 CFR 500.20(s)(1)).

(17) *SHOP dependent coverage*. The term *SHOP dependent coverage* refers to coverage offered through SHOP separately to any individual who is or may become eligible for coverage under the terms of a group health plan offered through SHOP because of a relationship to a participant-employee, whether or not a dependent of the participant-employee under section 152 of the Internal Revenue Code. The term *SHOP dependent coverage* does not include coverage such as family coverage, which includes coverage of the participant-employee.

(18) *Small Business Health Options Program (SHOP)*. The term *Small Business Health Options Program (SHOP)* means an Exchange established pursuant to section 1311 of the Affordable Care Act and defined in 45 CFR 155.20.

(19) *State*. The term *State* means a State as defined in section 7701(a)(10), including the District of Columbia.

(20) *Tax-exempt eligible small employer*. The term *tax-exempt eligible small employer* means an eligible small employer that is exempt from federal income tax under section 501(a) as an organization described in section 501(c).

(21) *Tier*. The term *tier* refers to a category of coverage under a benefits package that varies only by the number of individuals covered. For example, employee-only coverage, dependent coverage, and family coverage would constitute three separate tiers of coverage.

(22) *Tobacco surcharge*. The term *tobacco surcharge* means any allowable differential that is charged for insurance in the SHOP Exchange that is attributable to tobacco use as the term tobacco use is defined in 45 CFR 147.102(a)(1)(iv).

(23) *United States*. The term *United States* means United States as defined in section 7701(a)(9).

(24) *Wages*. The term *wages* for purposes of section 45R means wages as defined under section 3121(a) for purposes of the Federal Insurance Contributions Act (FICA), determined without regard to the social security wage base limitation under section 3121(a)(1).

(25) *Wellness program*. The term *wellness program* for purposes of section 45R means a program of health promotion or disease prevention subject to the requirements of § 54.9802–1(f).

(b) *Effective/applicability date*. This section is applicable for periods after 2013. For rules relating to certain plan years beginning in 2014, see § 1.45R–3(i).

[T.D. 9672, 79 FR 36646, June 30, 2014]

§ 1.45R–2 Eligibility for the credit.

(a) *Eligible small employer*. To be eligible for the credit under section 45R, an employer must be an eligible small employer. In order to be an eligible small employer, with respect to any taxable year, an employer must have no more than 25 full-time equivalent employees

(FTEs), must have in effect a qualifying arrangement, and the average annual wages of the employer's FTEs must not exceed an amount equal to twice the dollar amount in effect under § 1.45R–3(c)(2). For purposes of eligibility for the credit for taxable years beginning in or after 2014, a qualifying arrangement is an arrangement that requires an employer to make a nonelective contribution on behalf of each employee who enrolls in a qualified health plan (QHP) offered to employees through a small business health options program (SHOP) Exchange in an amount equal to a uniform percentage (not less than 50 percent) of the premium cost of the QHP. Notwithstanding the foregoing, an employer that is an agency or instrumentality of the federal government, or of a State, local or Indian tribal government, is not an eligible small employer if it is not an organization described in section 501(c) that is exempt from tax under section 501(a). An employer does not fail to be an eligible small employer merely because its employees are not performing services in a trade or business of the employer. An employer located outside the United States (including an employer located in a U.S. territory) must have income effectively connected with the conduct of a trade or business in the United States, and otherwise meet the requirements of this section, to be an eligible small employer. For eligibility standards for SHOP related to foreign employers, see 45 CFR 155.710. Paragraphs (b) through (f) of this section provide the rules for determining whether the requirements to be an eligible small employer are met, including rules related to identifying and counting the number of the employer's FTEs, counting the employees' hours of service, and determining the employer's average annual FTE wages for the taxable year. For rules on determining whether the uniform percentage requirement is met, see § 1.45R–4.

(b) *Application of section 414 employer aggregation rules.* All employers treated as a single employer under section 414(b), (c), (m) or (o) are treated as a single employer for purposes of this section. Thus, all employees of a controlled group under section 414(b), (c) or (o), or an affiliated service group under section 414(m), are taken into account in determining whether any member of the controlled group or affiliated service group is an eligible small employer. Similarly, all wages paid to, and premiums paid for, employees by the members of the controlled group or affiliated service group are taken into account when determining the amount of the credit for a group treated as a single employer under these rules.

(c) *Employees taken into account.* To be eligible for the credit, an employer must have employees as defined in § 1.45R–1(a)(5) during the taxable year. All such employees of the eligible small employer are taken into account for purposes of determining the employer's FTEs and average annual FTE wages. Employees include employees who terminate employment during the year for which the credit is being claimed, employees covered under a collective bargaining agreement, and employees who do not enroll in a QHP offered by the employer through a SHOP Exchange.

(d) *Determining the hours of service performed by employees*—(1) *In general.* An employee's hours of service for a year include each hour for which an employee is paid, or entitled to payment, for the performance of duties for the employer during the employer's taxable year. It also includes each hour for which an employee is paid, or entitled to payment, by the employer on account of a period of time during which no duties are performed due to vacation, holiday, illness, incapacity (including disability), layoff, jury duty, military duty or leave of absence (except that no more than 160 hours of service are required to be counted for an employee on account of any single continuous period during which the employee performs no duties).

(2) *Permissible methods.* In calculating the total number of hours of service that must be taken into account for an employee during the taxable year, eligible small employers need not use the same method for all employees, and may apply different methods for different classifications of employees if the classifications are reasonable and consistently applied. Eligible small

employers may change the method for calculating employees' hours of service for each taxable year. An eligible small employer may use any of the following three methods.

(i) *Actual hours worked.* An employer may use the actual hours of service provided by employees including hours worked and any other hours for which payment is made or due (as described in paragraph (d)(1) of this section).

(ii) *Days-worked equivalency.* An employer may use a days-worked equivalency whereby the employee is credited with 8 hours of service for each day for which the employee would be required to be credited with at least one hour of service under paragraph (d)(1) of this section.

(iii) *Weeks-worked equivalency.* An employer may use a weeks-worked equivalency whereby the employee is credited with 40 hours of service for each week for which the employee would be required to be credited with at least one hour of service under paragraph (d)(1) of this section.

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

Example 1. Counting hours of service by hours actually worked or for which payment is made or due. (i) *Facts.* An eligible small employer (Employer) has payroll records that indicate that Employee A worked 2,000 hours and that Employer paid Employee A for an additional 80 hours on account of vacation, holiday and illness. Employer uses the actual hours worked method described in paragraph (d)(2)(i) of this section.

(ii) *Conclusion.* Under this method of counting hours, Employee A must be credited with 2,080 hours of service (2,000 hours worked and 80 hours for which payment was made or due).

Example 2. Counting hours of service under days-worked equivalency. (i) *Facts.* Employee B worked from 8:00 am to 12:00 pm every day for 200 days. Employer uses the days-worked equivalency method described in paragraph (d)(2)(ii) of this section.

(ii) *Conclusion.* Under this method of counting hours, Employee B must be credited with 1,600 hours of service (8 hours for each day Employee B would otherwise be credited with at least 1 hour of service × 200 days).

Example 3. Counting hours of service under weeks-worked equivalency. (i) *Facts.* Employee C worked 49 weeks, took 2 weeks of vacation with pay, and took 1 week of leave without pay. Employer uses the weeks-worked equivalency method described in paragraph (d)(2)(iii) of this section.

(ii) *Conclusion.* Under this method of counting hours, Employee C must be credited with 2,040 hours of service (40 hours for each week during which Employee C would otherwise be credited with at least 1 hour of service × 51 weeks).

Example 4. Excluded employees. (i) *Facts.* Employee D worked 3 consecutive weeks at 32 hours per week during the holiday season. Employee D did not work during the remainder of the year. Employee E worked limited hours after school from time to time through the year for a total of 350 hours. Employee E does not work through the summer. Employer uses the actual hours worked method described in paragraph (d)(2)(i) of this section.

(ii) *Conclusion.* Employee D is a seasonal employee who worked for 120 days or less for Employer during the year. Employee D's hours are not counted when determining the hours of service of Employer's employees. Employee E works throughout most of the year and is not a seasonal employee. Employer counts Employee E's 350 hours of service during the year.

(e) *FTE Calculation*—(1) *In general.* The number of an employer's FTEs is determined by dividing the total hours of service, determined in accordance with paragraph (d) of this section, credited during the year to employees taken into account under paragraph (c) of this section (but not more than 2,080 hours for any employee) by 2,080. The result, if not a whole number, is then rounded to the next lowest whole number. If, however, after dividing the total hours of service by 2,080, the resulting number is less than one, the employer rounds up to one FTE.

(2) *Example.* The following example illustrates the provisions of paragraph (e) of this section:

Example. Determining the number of FTEs. (i) *Facts.* A sole proprietor pays 5 employees wages for 2,080 hours each, pays 3 employees wages for 1,040 hours each, and pays 1 employee wages for 2,300 hours. One of the employees working 2,080 hours is the sole proprietor's nephew. The sole proprietor's FTEs would be calculated as follows: 8,320 hours of service for the 4 employees paid for 2,080 hours each (4 × 2,080); the sole proprietor's nephew is excluded from the FTE calculation; 3,120 hours of service for the 3 employees paid for 1,040 hours each (3 × 1,040); and 2,080 hours of service for the 1 employee paid for 2,300 hours (lesser of 2,300 and 2,080). The sum of the included hours of service equals 13,520 hours of service.

(ii) *Conclusion.* The sole proprietor's FTEs equal 6 (13,520 divided by 2,080 = 6.5, rounded to the next lowest whole number).

(f) *Determining the employer's average annual FTE wages*—(1) *In general.* All wages paid to employees (including overtime pay) are taken into account in computing an eligible small employer's average annual FTE wages. The average annual wages paid by an employer for a taxable year is determined by dividing the total wages paid by the eligible small employer during the employer's taxable year to employees taken into account under paragraph (c) of this section by the number of the employer's FTEs for the year. The result is then rounded down to the nearest $1,000 (if not otherwise a multiple of $1,000). For purposes of determining the employer's average annual wages for the taxable year, only wages that are paid for hours of service determined under paragraph (d) of this section are taken into account.

(2) *Example.* The following example illustrates the provision of paragraphs (e) and (f) of this section:

Example. (i) *Facts.* An employer has 26 FTEs with average annual wages of $23,000. Only 22 of the employer's employees enroll for coverage offered by the employer through a SHOP Exchange.

(ii) *Conclusion.* The hours of service and wages of all employees are taken into consideration in determining whether the employer is an eligible small employer for purposes of the credit. Because the employer does not have fewer than 25 FTEs for the taxable year, the employer is not an eligible small employer for purposes of this section, even if fewer than 25 employees (or FTEs) enroll for coverage through the SHOP Exchange.

(g) *Effective/applicability date.* This section is applicable for periods after 2013. For transition rules relating to certain plan years beginning in 2014, see §1.45R–3(i).

[T.D. 9672, 79 FR 36646, June 30, 2014]

§ 1.45R–3 Calculating the credit.

(a) *In general.* The tax credit available to an eligible small employer equals 50 percent of the eligible small employer's premium payments made on behalf of its employees under a qualifying arrangement, or in the case of a tax-exempt eligible small employer, 35 percent of the employer's premium payments made on behalf of its employees under a qualifying arrangement. The employer's tax credit is subject to the following adjustments and limitations:

(1) The average premium limitation for the small group market in the rating area in which the employee enrolls for coverage, described in paragraph (b) of this section;

(2) The credit phaseout described in paragraph (c) of this section;

(3) The net premium payment limitation in the case of State credits or subsidies described in paragraph (d) of this section;

(4) The payroll tax limitation for a tax-exempt eligible small employer described in paragraph (e) of this section;

(5) The two-consecutive-taxable year-credit period limitation, described in paragraph (f) of this section;

(6) The rules with respect to the premium payments taken into account, described in paragraph (g) of this section;

(7) The rules with respect to credits applicable to trusts, estates, regulated investment companies, real estate investment trusts and cooperatives described in paragraph (h) of this section; and

(8) The transition relief for 2014 described in paragraph (i) of this section.

(b) *Average premium limitation*—(1) *In general.* The amount of an eligible small employer's premium payments that is taken into account in calculating the credit is limited to the premium payments the employer would have made under the same arrangement if the average premium for the small group market in the rating area in which the employee enrolls for coverage were substituted for the actual premium.

(2) *Examples.* The following examples illustrate the provisions of paragraph (b)(1) of this section:

Example 1. Comparing premium payments to average premium for small group market. (i) *Facts.* An eligible small employer (Employer) offers a health insurance plan with employee-only and SHOP dependent coverage through a small business options program (SHOP) Exchange. Employer has 9 full-time equivalent employees (FTEs) with average annual wages of $23,000 per FTE. All 9 employees are employees as defined under

§ 1.45R–1(a)(5). Six employees are enrolled in employee-only coverage and 5 of these 6 employees have also enrolled either one child or one spouse in SHOP dependent coverage. Employer pays 50% of the premiums for all employees enrolled in employee-only coverage and 50% of the premiums for all employees who enrolled family members in SHOP dependent coverage (and the employee is responsible for the remainder in each case). The premiums are $4,000 a year for employee-only coverage and $3,000 a year for each individual enrolled in SHOP dependent coverage. The average premium for the small group market in Employer's rating area is $5,000 for employee-only coverage and $4,000 for each individual enrolled in SHOP dependent coverage. Employer's premium payments for each FTE ($2,000 for employee-only coverage and $1,500 for SHOP dependent coverage) do not exceed 50 percent of the average premium for the small group market in Employer's rating area ($2,500 for employee-only coverage and $2,000 for each individual enrolled in SHOP dependent coverage).

(ii) *Conclusion.* The amount of premiums paid by Employer for purposes of computing the credit equals $19,500 ((6 × $2,000) plus (5 × $1,500)).

Example 2. Premium payments exceeding average premium for small group market. (i) *Facts.* Same facts as *Example* 1, except that the premiums are $6,000 for employee-only coverage and $5,000 for each dependent enrolled in coverage. Employer's premium payments for each employee ($3,000 for employee-only coverage and $2,500 for SHOP dependent coverage) exceed 50% of the average premium for the small group market in Employer's rating area ($2,500 for self-only coverage and $2,000 for family coverage).

(ii) *Conclusion.* The amount of premiums paid by Employer for purposes of computing the credit equals $25,000 ((6 × $2,500) plus (5 × $2,000)).

(c) *Credit phaseout*—(1) *In general.* The tax credit is subject to a reduction (but not reduced below zero) if the employer's FTEs exceed 10 or average annual FTE wages exceed $25,000. If the number of FTEs exceeds 10, the reduction is determined by multiplying the otherwise applicable credit amount by a fraction, the numerator of which is the number of FTEs in excess of 10 and the denominator of which is 15. If average annual FTE wages exceed $25,000, the reduction is determined by multiplying the otherwise applicable credit amount by a fraction, the numerator of which is the amount by which average annual FTE wages exceed $25,000 and the denominator of which is $25,000. In both cases, the result of the calculation is subtracted from the otherwise applicable credit to determine the credit to which the employer is entitled. For an employer with both more than 10 FTEs and average annual FTE wages exceeding $25,000, the total reduction is the sum of the two reductions.

(2) *$25,000 dollar amount adjusted for inflation.* For taxable years beginning in a calendar year after 2013, each reference to ''$25,000'' in paragraph (c)(1) of this section is replaced with a dollar amount equal to $25,000 multiplied by the cost-of-living adjustment under section 1(f)(3) for the calendar year, determined by substituting ''calendar year 2012'' for ''calendar year 1992'' in section 1(f)(3)(B).

(3) *Examples.* The following examples illustrate the provisions of paragraph (c) this section. For purposes of these examples, no employer is a tax-exempt organization and no other adjustments or limitations on the credit apply other than those adjustments and limitations explicitly set forth in the example.

Example 1. Calculating the maximum credit for an eligible small employer without an applicable credit phaseout. (i) *Facts.* An eligible small employer (Employer) has 9 FTEs with average annual wages of $23,000. Employer pays $72,000 in health insurance premiums for those employees (which does not exceed the total average premium for the small group market in the rating area), and otherwise meets the requirements for the credit.

(ii) *Conclusion.* Employer's credit equals $36,000 (50% × $72,000).

Example 2. Calculating the credit phaseout if the number of FTEs exceeds 10 or average annual wages exceed $25,000, as adjusted for inflation. (i) *Facts.* An eligible small employer (Employer) has 12 FTEs and average annual FTE wages of $30,000 in a year when the amount in paragraph (c)(1) of this section, as adjusted for inflation, is $25,000. Employer pays $96,000 in health insurance premiums for its employees (which does not exceed the average premium for the small group market in the rating area) and otherwise meets the requirements for the credit.

(ii) *Conclusion.* The initial amount of the credit is determined before any reduction (50% × $96,000) = $48,000. The credit reduction for FTEs in excess of 10 is $6,400 ($48,000 × 2/15). The credit reduction for average annual FTE wages in excess of $25,000 is $9,600 ($48,000 × $5,000/$25,000), resulting in a total credit reduction of $16,000 ($6,400 + $9,600). Employer's total tax credit equals $32,000 ($48,000 – $16,000).

(d) *State credits and subsidies for health insurance*—(1) *Payments to employer*. If the employer is entitled to a State tax credit or a premium subsidy that is paid directly to the employer, the premium payment made by the employer is not reduced by the credit or subsidy for purposes of determining whether the employer has satisfied the requirement to pay an amount equal to a uniform percentage (not less than 50 percent) of the premium cost. Also, except as described in paragraph (d)(3) of this section, the maximum amount of the credit is not reduced by reason of a State tax credit or subsidy or by reason of payments by a State directly to an employer.

(2) *Payments to issuer*. If a State makes payments directly to an insurance company (or another entity licensed under State law to engage in the business of insurance) to pay a portion of the premium for coverage of an employee enrolled for coverage through a SHOP Exchange, the State is treated as making these payments on behalf of the employer for purposes of determining whether the employer has satisfied the requirement to pay an amount equal to a uniform percentage (not less than 50 percent) of the premium cost of coverage. Also, except as described below in paragraph (d)(3) of this section, these premium payments by the State are treated as an employer contribution under this section for purposes of calculating the credit.

(3) *Credits may not exceed net premium payment*. Regardless of the application of paragraphs (d)(1) and (2) of this section, in no event may the amount of the credit exceed the amount of the employer's net premium payments as defined in §1.45R–1(a)(11).

(4) *Examples*. The following examples illustrate the provisions of paragraphs (d)(1) through (3) of this section. For purposes of these examples, each employer is an eligible small employer that is not a tax-exempt organization and the eligible small employer's taxable year and plan year begin during or after 2014. No other adjustments or limitations on the credit apply other than those adjustments and limitations explicitly set forth in the example.

Example 1. State premium subsidy paid directly to employer. (i) *Facts*. The State in which an eligible small employer (Employer) operates provides a health insurance premium subsidy of up to 40% of the health insurance premiums for each eligible employee. The State pays the subsidy directly to Employer. Employer has one employee, Employee D. Employee D's health insurance premiums are $100 per month and are paid as follows: $80 by Employer and $20 by Employee D through salary reductions to a cafeteria plan. The State pays Employer $40 per month as a subsidy for Employer's payment of insurance premiums on behalf of Employee D. Employer is otherwise an eligible small employer that meets the requirements for the credit.

(ii) *Conclusion*. For purposes of calculating the credit, the amount of premiums paid by the employer is $80 per month (the premium payment by the Employer without regard to the subsidy from the State). The maximum credit is $40 ($\$80 \times 50\%$).

Example 2. State premium subsidy paid directly to insurance company. (i) *Facts*. The State in which Employer operates provides a health insurance premium subsidy of up to 30% for each eligible employee. Employer has one employee, Employee E. Employee E is enrolled in employee-only coverage through a qualified health plan (QHP) offered by Employer through a SHOP Exchange. Employee E's health insurance premiums are $100 per month and are paid as follows: $50 by Employer; $30 by the State and $20 by the employee. The State pays the $30 per month directly to the insurance company and the insurance company bills Employer for the employer and employee's share, which equal $70 per month. Employer is otherwise an eligible small employer that meets the requirements for the credit.

(ii) *Conclusion*. For purposes of calculating the amount of the credit, the amount of premiums paid by Employer is $80 per month (the sum of Employer's payment and the State's payment). The maximum credit is $40 ($\$80 \times 50\%$).

Example 3. Credit limited by employer's net premium payment. (i) *Facts*. The State in which Employer operates provides a health insurance premium subsidy of up to 50% for each eligible employee. Employer has one employee, Employee F. Employee F is enrolled in employee-only coverage under the QHP offered to Employee F by Employer through a SHOP Exchange. Employee F's health insurance premiums are $100 per month and are paid as follows: $20 by Employer; $50 by the State and $30 by Employee F. The State pays the $50 per month directly to the insurance company and the insurance company bills Employer for the employer's and employee's shares, which total $50 per month. The amount of premiums paid by Employer (the sum of Employer's payment and the State's payment) is $70 per month, which is more than 50% of the $100 monthly premium payment. The amount of the premium for calculating the credit is also $70 per month.

(ii) *Conclusion.* The maximum credit without adjustments or limitations is $35 ($70 × 50%). Employer's net premium payment is $20 (the amount actually paid by Employer excluding the State subsidy). Because the credit may not exceed Employer's net premium payment, the credit is $20 (the lesser of $35 or $20).

(e) *Payroll tax limitation for tax-exempt eligible small employers*—(1) *In general.* For a tax-exempt eligible employer, the amount of the credit claimed cannot exceed the total amount of payroll taxes (as defined in § 1.45R–1(a)(13)) of the employer during the calendar year in which the taxable year begins.

(2) *Example.* The following example illustrates the provisions of paragraph (e)(1) of this section. For purposes of this example, the eligible small employer's taxable year and plan year begin during or after 2014. No other adjustments or limitations on the credit apply other than those adjustments and limitations explicitly set forth in the example.

Example. Calculating the maximum credit for a tax-exempt eligible small employer. (i) *Facts.* Employer is a tax-exempt eligible small employer that has 10 FTEs with average annual wages of $21,000. Employer pays $80,000 in health insurance premiums for its employees (which does not exceed the average premium for the small group market in the rating area) and otherwise meets the requirements for the credit. The total amount of Employer's payroll taxes equals $30,000.

(ii) *Conclusion.* The initial amount of the credit is determined before any reduction: (35% × $80,000) = $28,000, and Employer's payroll taxes are $30,000. The total tax credit equals $28,000 (the lesser of $28,000 and $30,000).

(f) *Two-consecutive-taxable-year credit period limitation.* The credit is available to an eligible small employer, including a tax-exempt eligible small employer, only during that employer's credit period. For a transition rule for 2014, see paragraph (i) of this section. To prevent the avoidance of the two-year limit on the credit period through the use of successor entities, a successor entity and a predecessor entity are treated as the same employer. For this purpose, the rules for identifying successor entities under § 31.3121(a)(1)–1(b) apply. Accordingly, for example, if an eligible small employer claims the credit for the 2014 and 2015 taxable years, that eligible small employer's credit period will have expired so that any successor employer to that eligible small employer will not be able to claim the credit for any subsequent taxable years.

(g) *Premium payments by the employer for a taxable year*—(1) *In general.* Only premiums paid by an eligible small employer or tax-exempt eligible small employer on behalf of each employee enrolled in a QHP or payments paid to the issuer in accordance with paragraph (d)(2) of this section are counted in calculating the credit. If an eligible small employer pays only a portion of the premiums for the coverage provided to employees (with employees paying the rest), only the portion paid by the employer is taken into account. Premiums paid on behalf of seasonal workers may be counted in determining the amount of the credit (even though seasonal worker wages and hours of service are not included in the FTE calculation and average annual FTE wage calculation unless the seasonal worker works for the employer on more than 120 days during the taxable year). Subject to the average premium limitation, premiums paid on behalf of an employee with respect to any individuals who are or may become eligible for coverage under the terms of the plan because of a relationship to the employee (including through family coverage or SHOP dependent coverage) may also be taken into account in determining the amount of the credit. (However, premiums paid for SHOP dependent coverage are not taken into account in determining whether the uniform percentage requirement is met, see § 1.45R–4(b)(5).)

(2) *Excluded amounts*—(i) *Salary reduction amounts.* Any premium paid pursuant to a salary reduction arrangement under a section 125 cafeteria plan is not treated as paid by the employer for purposes of section 45R and these regulations. For this purpose, premiums paid with employer-provided flex credits that employees may elect to receive as cash or other taxable benefits are

treated as paid pursuant to a salary reduction arrangement under a section 125 cafeteria plan.

(ii) *HSAs, HRAs, and FSAs.* Employer contributions to, or amounts made available under, health savings accounts, reimbursement arrangements, and health flexible spending arrangements are not taken into account in determining the premium payments by the employer for a taxable year.

(h) *Rules applicable to trusts, estates, regulated investment companies, real estate investment trusts and cooperative organizations.* Rules similar to the rules of section 52(d) and (e) and the regulations thereunder apply in calculating and apportioning the credit with respect to a trust, estate, a regulated investment company or real estate investment trusts or cooperative organization.

(i) *Transition rule for 2014*—(1) *In general.* This paragraph (i) applies if as of August 26, 2013, an eligible small employer offers coverage for a health plan year that begins on a date other than the first day of its taxable year. In such a case, if the eligible small employer has a health plan year beginning after January 1, 2014 but before January 1, 2015 (2014 health plan year) that begins after the start of its first taxable year beginning on or after January 1, 2014 (2014 taxable year), and the employer offers one or more QHPs to its employees through a SHOP Exchange as of the first day of its 2014 health plan year, then the eligible small employer is treated as offering coverage through a SHOP Exchange for its entire 2014 taxable year for purposes of section 45R if the health care coverage provided from the first day of the 2014 taxable year through the day immediately preceding the first day of the 2014 health plan year would have qualified for a credit under section 45R using the rules applicable to taxable years beginning before January 1, 2014. If the eligible small employer claims the section 45R credit in the 2014 taxable year, the 2014 taxable year begins the first year of the credit period.

(2) *Example.* The following example illustrates the rule of this paragraph (i) of this section. For purposes of this example, it is assumed that the eligible small employer is not a tax-exempt organization and that no other adjustments or limitations on the credit apply other than those adjustments and limitations explicitly set forth in the example.

Example. (i) *Facts.* An eligible small employer (Employer) has a 2014 taxable year that begins January 1, 2014 and ends on December 31, 2014. As of August 26, 2013, Employer had a 2014 health plan year that begins July 1, 2014 and ends June 30, 2015. Employer offers a QHP through a SHOP Exchange the coverage under which begins July 1, 2014. Employer also provides other coverage from January 1, 2014 through June 30, 2014 that would have qualified for a credit under section 45R based on the rules applicable to taxable years beginning before 2014.

(ii) *Conclusion.* Employer may claim the credit at the 50% rate under section 45R for the entire 2014 taxable year using the rules under this paragraph (i) of this section. Accordingly, in calculating the credit, Employer may count premiums paid for the coverage from January 1, 2014 through June 30, 2014, as well as premiums paid for the coverage from July 1, 2014 through December 31, 2014. If Employer claims the credit for the 2014 taxable year, that taxable year is the first year of the credit period.

(j) *Effective/applicability date.* This section is applicable for periods after 2013. For transition rules relating to certain plan years beginning in 2014, see paragraph (i) of this section.

[T.D. 9672, 79 FR 36646, June 30, 2014]

§ 1.45R–4 Uniform percentage of premium paid.

(a) *In general.* An eligible small employer must pay a uniform percentage (not less than 50 percent) of the premium for each employee enrolled in a qualified health plan (QHP) offered to employees by the employer through a small business health options program (SHOP) Exchange.

(b) *Employers offering one QHP.* An employer that offers a single QHP through a SHOP Exchange must satisfy the requirements of this paragraph (b).

(1) *Employers offering one QHP, employee-only coverage, composite billing.* For an eligible small employer offering employee-only coverage and using composite billing, the employer satisfies the requirements of this paragraph if it pays the same amount toward the premium for each employee receiving employee-only coverage under the QHP, and that amount is equal to at

least 50 percent of the premium for employee-only coverage.

(2) *Employers offering one QHP, other tiers of coverage, composite billing.* For an eligible small employer offering one QHP providing at least one tier of coverage with a higher premium than employee-only coverage and using composite billing, the employer satisfies the requirements of this paragraph (b)(2) if it either—

(i) Pays an amount for each employee enrolled in that more expensive tier of coverage that is the same for all employees and that is no less than the amount that the employer would have contributed toward employee-only coverage for that employee, or

(ii) Meets the requirements of paragraph (b)(1) of this section for each tier of coverage that if offers.

(3) *Employers offering one QHP, employee-only coverage, list billing.* For an eligible small employer offering one QHP providing only employee-only coverage and using list billing, the employer satisfies the requirements of this paragraph (b)(3) if either—

(i) The employer pays toward the premium an amount equal to a uniform percentage (not less than 50 percent) of the premium charged for each employee, or

(ii) The employer converts the individual premiums for employee-only coverage into an employer-computed composite rate for self-only coverage, and, if an employee contribution is required, each employee who receives coverage under the QHP pays a uniform amount toward the employee-only premium that is no more than 50 percent of the employer-computed composite rate for employee-only coverage.

(4) *Employers offering one QHP, other tiers of coverage, list billing.* For an eligible small employer offering one QHP providing at least one tier of coverage with a higher premium than employee-only coverage and using list billing, the employer satisfies the requirements of this paragraph (b)(4) if it either—

(i) Pays toward the premium for each employee covered under each tier of coverage an amount equal to or exceeding the amount that the employer would have contributed with respect to that employee for employee-only coverage, calculated either based upon the actual premium that would have been charged by the insurer for that employee for employee-only coverage or based upon the employer-computed composite rate for employee-only coverage, or

(ii) Meets the requirements of paragraph (b)(3) of this section for each tier of coverage that it offers substituting the employer-computed composite rate for each tier of coverage for the employer-computed composite rate for employee-only coverage.

(5) *Employers offering SHOP dependent coverage.* If SHOP dependent coverage is offered through the SHOP Exchange, the employer does not fail to satisfy the uniform percentage requirement by contributing a different amount toward that SHOP dependent coverage, even if that contribution is zero. For treatment of premiums paid on behalf of an employee's dependents, see §1.45R–3(g)(1).

(c) *Employers offering more than one QHP.* If an eligible small employer offers more than one QHP, the employer must satisfy the requirements of this paragraph (c). The employer may satisfy the requirements of this paragraph (c) in either of the following two ways:

(1) *QHP-by-QHP method.* The employer makes payments toward the premium with respect to each QHP for which the employer is claiming the credit that satisfy the uniform percentage requirement under paragraph (b) of this section on a QHP-by-QHP basis (so that the amounts or percentages of premium paid by the employer for each QHP need not be identical, but the payments with respect to each QHP must satisfy paragraph (b) of this section); or

(2) *Reference QHP method.* The employer designates a reference QHP and makes employer contributions in accordance with the following requirements—

(i) The employer determines a level of employer contributions for each employee such that, if all eligible employees enrolled in the reference QHP, the contributions would satisfy the uniform percentage requirement under paragraph (b) of this section, and

(ii) The employer allows each employee to apply an amount of employer contribution determined necessary to meet the uniform percentage requirement under paragraph (b) of this section either toward the reference QHP or toward the cost of coverage under any of the other available QHPs.

(d) *Tobacco surcharges and wellness program discounts or rebates*—(i) *Tobacco surcharges.* The tobacco surcharge and amounts paid by the employer to cover the surcharge are not included in premiums for purposes of calculating the uniform percentage requirement, nor are payments of the surcharge treated as premium payments for purposes of calculating the credit. The uniform percentage requirement is also applied without regard to employee payment of the tobacco surcharges in cases in which all or part of the employee tobacco surcharges are not paid by the employer.

(ii) *Wellness programs.* If a plan of an employer provides a wellness program, for purposes of meeting the uniform percentage requirement any additional amount of the employer contribution attributable to an employee's participation in the wellness program over the employer contribution with respect to an employee that does not participate in the wellness program is not taken into account in calculating the uniform percentage requirement, whether the difference is due to a discount for participation or a surcharge for nonparticipation. The employer contribution for employees that do not participate in the wellness program must be at least 50 percent of the premium (including any premium surcharge for nonparticipation). However, for purposes of computing the credit, the employer contributions are taken into account, including those contributions attributable to an employee's participation in a wellness program.

(e) *Special rules regarding employer compliance with applicable State or local law.* An employer will be treated as satisfying the uniform percentage requirement if the failure to otherwise satisfy the uniform percentage requirement is attributable solely to additional employer contributions made to certain employees to comply with an applicable State or local law.

(f) *Examples.* The following examples illustrate the provisions of paragraphs (a) through (e) of this section:

Example 1. (i) *Facts.* An eligible small employer (Employer) offers a QHP on a SHOP Exchange, Plan A, which uses composite billing. The premiums for Plan A are $5,000 per year for employee-only coverage, and $10,000 for family coverage. Employees can elect employee-only or family coverage under Plan A. Employer pays $3,000 (60% of the premium) toward employee-only coverage under Plan A and $6,000 (60% of the premium) toward family coverage under Plan A.

(ii) *Conclusion.* Employer's contributions of 60% of the premium for each tier of coverage satisfy the uniform percentage requirement.

Example 2. (i) *Facts.* Same facts as *Example 1,* except that Employer pays $3,000 (60% of the premium) for each employee electing employee-only coverage under Plan A and pays $3,000 (30% of the premium) for each employee electing family coverage under Plan A.

(ii) *Conclusion.* Employer's contributions of 60% of the premium toward employee-only coverage and the same dollar amount toward the premium for family coverage satisfy the uniform percentage requirement, even though the percentage is not the same.

Example 3. (i) *Facts.* Employer offers two QHPs, Plan A and Plan B, both of which use composite billing. The premiums for Plan A are $5,000 per year for employee-only coverage and $10,000 for family coverage. The premiums for Plan B are $7,000 per year for employee-only coverage and $13,000 for family coverage. Employees can elect employee-only or family coverage under either Plan A or Plan B. Employer pays $3,000 (60% of the premium) for each employee electing employee-only coverage under Plan A, $3,000 (30% of the premium) for each employee electing family coverage under Plan A, $3,500 (50% of the premium) for each employee electing employee-only coverage under Plan B, and $3,500 (27% of the premium) for each employee electing family coverage under Plan B.

(ii) *Conclusion.* Employer's contributions of 60% (or $3,000) of the premiums for employee-only coverage and the same dollar amounts toward the premium for family coverage under Plan A, and of 50% (or $3,500) of the premium for employee-only of coverage and the same dollar amount toward the premium for family coverage under Plan B, satisfy the uniform percentage requirement on a QHP-by-QHP basis; therefore the employer's contributions to both plans satisfy the uniform percentage requirement.

Example 4. (i) *Facts.* Same facts as *Example 3,* except that Employer designates Plan A as the reference QHP. Employer pays $2,500 (50% of the premium) for each employee electing employee-only coverage under Plan

A and pays $2,500 of the premium for each employee electing family coverage under Plan A or either employee-only or family coverage under Plan B.

(ii) *Conclusion*. Employer's contribution of 50% (or $2,500) toward the premium of each employee enrolled under Plan A or Plan B satisfies the uniform percentage requirement.

Example 5. (i) *Facts*. Employer receives a list billing premium quote with respect to Plan X, a QHP offered by Employer on a SHOP Exchange for health insurance coverage for each of Employer's four employees. For Employee L, age 20, the employee-only premium is $3,000 per year, and the family premium is $8,000. For Employees M, N and O, each age 40, the employee-only premium is $5,000 per year and the family premium is $10,000. The total employee-only premium for the four employees is $18,000 ($3,000 + (3 × 5,000)). Employer calculates an employer-computed composite employee-only rate of $4,500 ($18,000/4). Employer offers to make contributions such that each employee would need to pay $2,000 of the premium for employee-only coverage. Under this arrangement, Employer would contribute $1,000 toward employee-only coverage for L and $3,000 toward employee-only coverage for M, N, and O. In the event an employee elects family coverage, Employer would make the same contribution ($1,000 for L or $3,000 for M, N, or O) toward the family premium.

(ii) *Conclusion*. Employer satisfies the uniform percentage requirement because it offers and makes contributions based on an employer-calculated composite employee-only rate such that, to receive employee-only coverage, each employee must pay a uniform amount which is not more than 50% of the composite rate, and it allows employees to use the same employer contributions toward family coverage.

Example 6. (i) *Facts*. Same facts as *Example 5*, except that Employer calculates an employer-computed composite family rate of $9,500 (($8,000 + 3 × 10,000)/4) and requires each employee to pay $4,000 of the premium for family coverage.

(ii) *Conclusion*. Employer satisfies the uniform percentage requirement because it offers and makes contributions based on a calculated employee-only and family rate such that, to receive either employee-only or family coverage, each employee must pay a uniform amount which is not more than 50% of the composite rate for coverage of that tier.

Example 7. (i) *Facts*. Same facts as *Example 5*, except that Employer also receives a list billing premium quote from Plan Y with respect to a second QHP offered by Employer on a SHOP Exchange for each of Employer's 4 employees. Plan Y's quote for Employee L, age 20, is $4,000 per year for employee-only coverage or $12,000 per year for family coverage. For Employees M, N and O, each age 40, the premium is $7,000 per year for employee-only coverage or $15,000 per year for family coverage. The total employee-only premium under Plan Y is $25,000 ($4,000 + (3 × 7,000)). The employer-computed composite employee-only rate is $6,250 ($25,000/4). Employer designates Plan X as the reference plan. Employer offers to make contributions based on the employer-calculated composite premium for the reference QHP (Plan X) such that each employee has to contribute $2,000 to receive employee-only coverage through Plan X. Under this arrangement, Employer would contribute $1,000 toward employee-only coverage for L and $3,000 toward employee-only coverage for M, N, and O. In the event an employee elects family coverage through Plan X or either employee-only or family coverage through Plan Y, Employer would make the same contributions ($1,000 for L or $3,000 for M, N, or O) toward that coverage.

(ii) *Conclusion*. Employer satisfies the uniform percentage requirement because it offers and makes contributions based on the employer-calculated composite employee-only premium for the Plan X reference QHP such that, in order to receive employee-only coverage, each employee must pay a uniform amount which is not more than 50% of the employee-only composite premium of the reference QHP; it allows employees to use the same employer contributions toward family coverage in the reference QHP or coverage through another QHPs.

Example 8. (i) *Facts*. Employer offers employee-only and SHOP dependent coverage through a QHP to its three employees using list billing. All three employees enroll in the employee-only coverage, and one employee elects to enroll two dependents in SHOP dependent coverage. Employer contributes 100% of the employee-only premium costs, but only contributes 25% of the premium costs toward SHOP dependent coverage.

(ii) *Conclusion*. Employer's contribution of 100% toward the premium costs of employee-only coverage satisfies the uniform percentage requirement, even though Employer is only contributing 25% toward SHOP dependent coverage.

Example 9. (i) *Facts*. Employer has five employees. Employer is located in a State that requires employers to pay 50% of employees' premium costs, but also requires that an employee's contribution not exceed a certain percentage of the employee's monthly gross earnings from that employer. Employer offers to pay 50% of the premium costs for all its employees, and to comply with the State law, Employer contributes more than 50% of the premium costs for two of its employees.

(ii) *Conclusion*. Employer satisfies the uniform percentage requirement because its failure to otherwise satisfy the uniform percentage requirement is attributable solely to compliance with the applicable State or local law.

Example 10. (i) *Facts.* Employer has three employees who all enroll in employee-only coverage. Employer is located in a State that has a tobacco surcharge on the premiums of employees who use tobacco. One of Employer's employees smokes. Employer contributes 50% of the employee-only premium costs, but does not cover any of the tobacco surcharge for the employee who smokes.

(ii) *Conclusion.* Employer's contribution of 50% toward the premium costs of employee-only coverage satisfies the uniform percentage requirement. Tobacco surcharges are not factored into premiums when calculating the uniform percentage requirement.

Example 11. (i) *Facts.* Employer has five employees who all enroll in employee-only coverage. Employer offers a wellness program that reduces the employee share of the premium for employees who participate in the wellness program. Employer contributes 50% of the premium costs of employee-only coverage for employees who do not participate in the wellness program and 55% of the premium costs of employee-only coverage for employees who participate in the wellness program. Three of the five employees participate in the wellness program.

(ii) *Conclusion.* Employer's contribution of 50% toward the premium costs of employee-only coverage for the two employees who do not participate in the wellness program and 55% toward the premium costs of employee-only coverage for three employees who participate in the wellness program satisfies the uniform percentage requirement because the additional 5% contribution due to the employees' participation in the wellness program is not taken into account. However, the additional 5% contributions are taken into account for purposes of calculating the credit.

(g) *Effective/applicability date.* This section is applicable for periods after 2013. For transition rules relating to certain plan years starting in 2014, see §1.45R–3(i).

[T.D. 9672, 79 FR 36646, June 30, 2014]

§ 1.45R–5 Claiming the credit.

(a) *Claiming the credit.* The credit is a general business credit. It is claimed on an eligible small employer's annual income tax return and offsets an employer's actual tax liability for the year. The credit is claimed by attaching Form 8941, ''Credit for Small Employer Health Insurance Premiums,'' to the eligible small employer's income tax return or, in the case of a tax-exempt eligible small employer, by attaching Form 8941 to the employer's Form 990–T, ''Exempt Organization Business Income Tax Return.'' To claim the credit, a tax-exempt eligible small employer must file a form 990–T with an attached Form 8941, even if a Form 990–T would not otherwise be required to be filed.

(b) *Estimated tax payments and alternative minimum tax (AMT) liability.* An eligible small employer may reflect the credit in determining estimated tax payments for the year in which the credit applies in accordance with the estimated tax rules as set forth in sections 6654 and 6655 and the applicable regulations. An eligible small employer may also use the credit to offset the employer's alternative minimum tax (AMT) liability for the year, if any, subject to certain limitations based on the amount of the employer's regular tax liability, AMT liability and other allowable credits. See section 38(c)(1), as modified by section 38(c)(4)(B)(vi). However, an eligible small employer, including a tax-exempt eligible small employer, may not reduce its deposits and payments of employment tax (that is, income tax required to be withheld under section 3402, social security and Medicare tax under sections 3101 and 3111, and federal unemployment tax under section 3301) during the year in anticipation of the credit.

(c) *Reduction of section 162 deduction.* No deduction under section 162 is allowed for the eligible small employer for that portion of the health insurance premiums that is equal to the amount of the credit under §1.45R–2.

(d) *Effective/applicability date.* This section is applicable for periods after 2013. For rules relating to certain plan years beginning in 2014, see §1.45R–3(i).

[T.D. 9672, 79 FR 36646, June 30, 2014]

§ 1.46–1 Determination of amount.

(a) *Effective dates*—(1) *In general.* This section is effective for taxable years beginning after December 31, 1975. However, transitional rules under paragraph (g) of this section are effective for certain earlier taxable years.

(2) *Acts covered.* This section reflects changes made by the following Acts of Congress:

Act and Section

Tax Reduction Act of 1975, section 301.
Tax Reform Act of 1976, sections 802, 1701, 1703.
Revenue Act of 1978, sections 311, 312, 315.
Energy Tax Act of 1978, section 301.
Economic Recovery Tax Act of 1981, section 212.
Technical Corrections Act of 1982, section 102(f).
Tax Reform Act of 1986, section 251.

(3) *Prior regulations.* For taxable years beginning before January 1, 1976, see 26 CFR 1.46–1 (Rev. as of April 1, 1979). Those regulations do not reflect changes made by Pub. L. 89–384, Pub. L. 89–389, and Pub. L. 91–172.

(b) *General rule.* The amount of investment credit (credit) allowed by section 38 for the taxable year is the portion of credit available under section 46(a)(1) that does not exceed the limitation based on tax under section 46(a)(3).

(c) *Credit available.* The credit available for the taxable year is the sum of—

(1) Unused credit carried over from prior taxable years under section 46(b) (carryovers).

(2) Amount of credit determined under section 46(a)(2) for the taxable year (credit earned), and

(3) Unused credit carried back from succeeding taxable years under section 46(b) (carrybacks).

(d) *Credit earned.* The credit earned for the taxable year is the sum of the following percentages of qualified investment (as determined under section 46 (c) and (d))—

(1) The regular percentage (as determined under section 46),

(2) For energy property, the energy percentage (as determined under section 46), and

(3) For the portion of the basis of a qualified rehabilitated building (as defined in § 1.48–12(b)) that is attributable to qualified rehabilitation expenditures (as defined in § 1.48–12(c)), the rehabilitation percentage (as determined under section 46(b)(4)).

(e) *Designation of credits.* The credit available for the taxable year is designated as follows:

(1) The credit attributable to the regular percentage is the ''regular credit''.

(2) The credit attributable to the ESOP percentage is the ''ESOP credit''.

(3) The credit attributable to the energy percentage for energy property other than solar or wind is the ''nonrefundable energy credit''.

(4) The credit attributable to the energy percentage for solar or wind energy property is the ''refundable energy credit''.

(5) The credit attributable to the rehabilitation percentage for qualified rehabilitation expenditures is the rehabilitation investment credit.

(f) *Special rules for certain energy property.* Energy property is defined in section 48(l). Under section 46(a)(2)(D), energy property that is section 38 property solely by reason of section 48(l)(1) qualifies only for the energy credit. Other energy property qualifies for both the regular credit (and, if applicable, the ESOP credit) and the energy credit. For limitation on the energy percentage for property financed by industrial development bonds, see section 48(l)(11).

(g) *Transitional rule for regular and ESOP credit*—(1) *In general.* Although section 46(a)(2) was amended by section 301(a)(1) of the Energy Tax Act of 1977 to eliminate the transitional rules under section 46(a)(2)(D), those rules still apply in certain instances. Section 46(a)(2)(D) was added by section 301(a) of the Tax Reduction Act of 1975 and amended by section 802(a) of the Tax Reform Act of 1976.

(2) *Regular credit.* Under section 46(a)(2)(D), the regular credit is 10 percent and applies for the following property:

(i) Property to which section 46 (d) does not apply, the construction, reconstruction, or erection of which is completed by the taxpayer after January 21, 1975, but only to the extent of basis attributable to construction, reconstruction, or erection after that date.

(ii) Property to which section 46(d) does not apply, acquired by the taxpayer after January 21, 1975.

(iii) Qualified progress expenditures (as defined in section 46(d)) made after January 21, 1975.

(3) *ESOP credit.* See section 48(m) for transitional rules limiting the period for which the ESOP percentage under section 46(a)(2)(E) applies. For prior statutes, see section 46(a)(2) (B) and

(D), as added by section 301 of the Tax Reduction Act of 1975 and amended by section 802 of the Tax Reform Act of 1976.

(4) *Cross reference.* (i) The principles of § 1.48–2 (b) and (c) apply in determining the portion of basis attributable to construction, reconstruction, or erection after January 21, 1975, and in determining the time when property is acquired.

(ii) Section 311 of the Revenue Act of 1978 made the 10 percent regular credit permanent.

(5) *Seven percent credit.* To the extent that, under paragraph (g)(1) of this section, the 10 percent does not apply, the regular credit, in general, is 7 percent. For a special limitation on qualified investment for public utility property (other than energy property), see section 46(c)(3)(A).

(6) *Qualified progress expenditures.* For progress expenditure property that is constructed, reconstructed, or erected by the taxpayer within the meaning of § 1.48–2(b), the ten-percent credit applies in the year the property is placed in service to the portion of the qualified investment that remains after reduction for qualified progress expenditures under section 46(c)(4), but only to the extent that the remaining qualified investment is attributable to construction, reconstruction, or erection after January 21, 1975. For progress expenditure property that is acquired by the taxpayer (within the meaning of § 1.48–2(b)) after January 21, 1975, and placed in service after that date, the ten-percent credit applies in the year the property is placed in service to the entire portion of qualified investment that remains after reduction for qualified progress expenditures.

(h) *Tax liability limitation*—(1) *In general.* Section 46(a)(3) provides a tax liability limitation on the amount of credit allowed by section 38 (other than the refundable energy credit) for any taxable year. See section 46(a)(10)(C)(i). Tax liability is defined in paragraph (j) of this section. The excess of available credit over the applicable tax liability limitation for the year is an unused credit which may be carried forward or carried back under section 46(b).

(2) *Regular and ESOP tax liability limitation.* In general, the tax liability limitation for the regular and ESOP credits is the portion of tax liability that does not exceed $25,000 plus a percentage of the excess, as determined under section 46(a)(3)(B).

(3) *Nonrefundable energy credit tax liability limitation.* (i) For nonrefundable energy credit carrybacks to a taxable year ending before October 1, 1978, the tax liability limitation is the portion of tax liability that does not exceed $25,000 plus a percentage of the excess, as determined under section 46(a)(3)(B).

(ii) For a taxable year ending after September 30, 1978, the tax liability limitation for available nonrefundable energy credit is 100 percent of the year's tax liability.

(4) *Alternative limitations.* Alternative limitations apply for certain utilities, railroads, and airlines in determining the regular tax liability limitation and, for nonrefundable energy credit carrybacks to taxable years ending before October 1, 1978, the nonrefundable energy credit tax liability limitation. These alternative limitations do not apply in determining the energy tax liability limitation for a taxable year ending after October 1, 1978. The provisions listed below set forth the alternative limitations:

Code section	Type	Years applicable
46(a)(6) [1]	Utilities	Taxable years ending in 1975–1978
46(a)(7) [2]	Utilities	Taxable year ending in 1979
46(a)(8)	Railroads and Airlines	Taxable year ending in 1979 or 1980
46(a)(8) [3]	Railroads	Taxable years ending in 1977 or 1978
46(a)(9) [3]	Airlines	Taxable years ending in 1977 or 1978

[1] Section 46(a)(6) was added by section 301(b)(2) of the Tax Reduction Act of 1975 and redesignated as section 46(a)(7) by section 302(a)(1) of the Tax Reform Act of 1976.

[2] Section 46(a)(7) was amended by section 312(b)(1) of the Revenue Act of 1978.

[3] These provisions were repealed by section 312(b)(2) of the Revenue Act of 1978.

(i) [Reserved]

(j) *Tax liability*—(1) *In general.* "Tax liability" for purposes of the regular and ESOP credit and carrybacks of nonrefundable energy credit to a taxable year ending before October 1, 1978, means the liability for tax as defined in section 46(a)(4). For ordering of regular, ESOP, and nonrefundable energy credits, see paragraph (m) of this section. In addition to taxes excluded under section 46(a)(4), tax liability does not include tax resulting from recapture of credit under section 47 and the alternative minimum tax imposed by section 55. See sections 47(c) and 55(c)(1).

(2) *Certain nonrefundable energy credit.* For a taxable year ending after September 30, 1978, ''tax liability'' for purposes of the nonrefundable energy credit is liability for tax, as defined in section 46(a)(4) and paragraph (j)(1) of this section, reduced by the regular and ESOP credit allowed for the taxable year. Thus, carrybacks of regular or ESOP credit to a taxable year may displace nonrefundable energy carryovers or credit earned taken into account in that year. However, carrybacks of regular, ESOP, or nonrefundable energy credit do not affect refundable energy credit which is treated as an overpayment of tax under section 6401(b). See paragraph (k) of this section.

(k) *Special rule for refundable energy credit.* The amount of the refundable energy credit is determined under the rules of section 46 (other than section 46(a)(3)). However, to permit the refund, the refundable energy credit for purposes of the Internal Revenue Code (other than section 38, part IVB, and chapter 63 of the Code) is treated as allowed by section 39 and not by section 38. The refundable credit is not applied against tax liability for purposes of determining the tax liability limitation for other investment credits. Rather, it is treated as an overpayment of tax under section 6401(b).

(l) *FIFO rule.* If the credit available for a taxable year is not allowed in full because of the tax liability limitation, special rules determine the order in which credits are applied. Under the first-in-first-out rule of section 46(a)(1) (FIFO), carryovers are applied against the tax liability limitation first. To the extent the tax liability limitation exceeds carryovers, credit earned, and carrybacks are then applied.

(m) *Special ordering rule*—(1) *In general.* Under section 46(a)(10)(A), the FIFO rule applies separately—

(i) First, with respect to regular and ESOP credits, and

(ii) Second, with respect to nonrefundable energy credit.

(2) *Regular and ESOP credit.* Under §1.46–8(c)(9)(ii), regular and ESOP credits available are applied in the following order:

(i) Regular carryovers;

(ii) ESOP carryovers;

(iii) Regular credit earned;

(iv) ESOP credit earned;

(v) Regular carrybacks; and

(vi) ESOP carrybacks.

(3) *Example.* For an example of the order of application of regular and ESOP credits, see §1.46–8(c)(9)(iii).

(n) *Examples.* The following examples illustrate paragraphs (a) through (m) of this section.

Example 1. (a) Corporation M's regular credit available for its taxable year ending December 31, 1979 is as follows:

Regular carryovers	$5,000
Regular credit earned	10,000
Regular carrybacks	15,000
Credit available	30,000

(b) M's ''tax liability'' for 1979 is $30,000. M's tax liability limitation for 1979 for the regular credit is $28,000, consisting of $25,000 plus 60 percent of the $5,000 of ''tax liability'' in excess of $25,000.

(c) The regular carryovers and credit earned are allowed in full. However, only $13,000 of the regular carryback is allowed for 1979. The remaining $2,000 must be carried to the next year to which it may be carried under section 46(b).

Example 2. (a) For its taxable year ending December 31, 1980, corporation N has $30,000 regular credit earned and $9,000 nonrefundable energy credit earned. N has no carryovers to 1980 and no ''tax liability'' for pre-1980 years.

(b) N's ''tax liability'' for 1980 for the regular credit is $35,000. N's tax liability limitation for 1980 for the regular credit is $32,000, consisting of $25,000 plus 70 percent of the $10,000 of ''tax liability'' in excess of $25,000.

(c) The entire regular credit is allowed in 1980.

(d) N's ''tax liability'' for 1980 for the nonrefundable energy credit is $5,000, consisting of $35,000 less $30,000 regular credit allowed for 1980. N's tax liability limitation for 1980 for the nonrefundable energy credit is 100 percent of $5,000.

(e) $5,000 of the nonrefundable energy credit is allowed for 1980. The remaining $4,000 energy credit is an unused nonrefundable energy credit which must be carried to the next year to which it may be carried under section 46(b).

Example 3. (a) Assume the same facts as in *Example 2* except that in its taxable year ending December 31, 1981, N earns a regular credit of which it may carry back $2,000 to 1980.

(b) The $30,000 regular credit earned and $2,000 of the regular carryback is allowed for 1980. N's ''tax liability'' for 1980 for the nonrefundable energy credit is reduced to $3,000, consisting of $35,000 less $32,000 regular credit allowed for 1980. The nonrefundable energy credit allowed for 1980 is reduced to $3,000. The remaining $6,000 is an unused nonrefundable energy credit which must be carried to the next year to which it may be carried under section 46(b).

Example 4. (a) For its taxable year ending December 31, 1980, corporation P's regular credit earned is $20,000. P also has a $9,000 refundable energy credit for 1980. There are no carryovers or carrybacks to 1980.

(b) P's ''tax liability'' for 1980 for the regular credit is $25,000 which is also the tax liability limitation for the regular credit.

(c) The entire $20,000 regular credit is allowed for 1980. The entire $9,000 refundable energy credit is treated as an overpayment of tax under section 6401(b), even though ''tax liability'' remains.

Example 5. Assume the same facts as in *Example 4*, except that in the following year P earns a regular credit, $5,000 of which it may carry back to 1980. The $5,000 carryback is allowed in full in 1980.

Example 6. (i) Corporation X, a calendar year taxpayer, constructs a ship on which it begins construction on January 1, 1973, and which, when placed in service on December 31, 1980, has a basis of $450,000. Of that amount, $100,000 is attributable to construction before January 22, 1975. X makes an election under section 46(d) (qualified progress expenditures) for taxable years after 1975.

(ii) For 1976, 1977, 1978, and 1979, qualified progress expenditures total $200,000. The ten-percent credit applies to those expenditures.

(iii) For 1980, qualified investment for the ship is $450,000. Under section 46(c)(4), X must reduce this amount by $200,000, the amount of qualified progress expenditures taken into account. The ten-percent credit applies to the portion of the remaining qualified investment attributable to construction after January 21, 1975 ($150,000). The seven-percent credit applies to the portion of qualified investment attributable to construction before January 22, 1975 ($100,000).

Example 7. (i) Corporation Y agrees to build a ship for Corporation X, which uses the calendar year. In 1973, Y begins construction of the ship which X acquires and places in service on December 31, 1980. X makes an election under section 46(d) for taxable years after 1974. The contract price is $400,000.

(ii) For 1975, 1976, 1977, 1978, and 1979, qualified progress expenditures total $250,000. The ten-percent credit applies to those expenditures.

(iii) For 1980, qualified investment for the ship is $400,000, which is the contract price. X must reduce qualified investment by $250,000, the amount of qualified progress expenditures. The ten-percent credit applies to the $150,000 of qualified investment that remains after reduction for qualified progress expenditures.

(o) *Married individuals.* If a separate return is filed by a husband or wife, the tax liability limitation is computed by substituting a $12,500 amount for the $25,000 amount that applies under section 46(a)(3). However, this reduction of the $25,000 amount to $12,500 applies only if the taxpayer's spouse is entitled to a credit under section 38 for the taxable year of such spouse which ends with, or within, the taxpayer's taxable year. The taxpayer's spouse is entitled to a credit under section 38 either because of investment made in qualified property for such taxable year of the spouse (whether directly made by such spouse or whether apportioned to such spouse, for example, from an electing small business corporation, as defined in section 1371(b)), or because of an investment credit carryback or carryover to such taxable year. The determination of whether an individual is married shall be made under the principles of section 143 and the regulations thereunder.

(p) *Apportionment of $25,000 amount among component members of a controlled group*—(1) *In general.* In determining the tax liability limitation under section 46(a)(3) for corporations that are component members of a controlled group on December 31, only one $25,000 amount is available to those component members for their taxable years that include that December 31. See subparagraph (2) of this paragraph for apportionment of such amount among such component members. See subparagraph (3) of this paragraph for definition of ''component member''.

(2) *Manner of apportionment.* (i) In the case of corporations which are component members of a controlled group on a particular December 31, the $25,000 amount may be apportioned among such members for their taxable years that include such December 31 in any manner the component members may select, provided that each such member less than 100 percent of whose stock is owned, in the aggregate, by the other component members of the group on

such December 31 consents to an apportionment plan. The consent of a component member to an apportionment plan with respect to a particular December 31 shall be made by means of a statement, signed by a person duly authorized to act on behalf of the consenting member, stating that such member consents to the apportionment plan with respect to such December 31. The statement shall set forth the name, address, employer identification number, and taxable year of each component member of the group on such December 31, the amount apportioned to each such member under the plan, and the location of the Service Center where the statement is to be filed. The consent of more than one component member may be incorporated in a single statement. The statement shall be timely filed with the Service Center where the component member having the taxable year first ending on or after such December 31 files its return for such taxable year and shall be irrevocable after such filing. If two or more component members have the same such taxable year, a statement of consent may be filed by any one of such members. However, if the due date (including any extensions of time) of the return of such member is on or before December 15, 1971, the required statement shall be considered as timely filed if filed on or before March 15, 1972. Each component member of the group on such December 31 shall keep as a part of its records a copy of the statement containing all the required consents.

(ii) An apportionment plan adopted by a controlled group with respect to a particular December 31 shall be valid only for the taxable year of each member of the group which includes such December 31. Thus, a controlled group must file a separate consent to an apportionment plan with respect to each taxable year which includes a December 31 as to which an apportionment plan is desired.

(iii) If the apportionment plan is not timely filed, the $25,000 amount specified in section 46(a)(3) shall be reduced for each component member of the controlled group, for its taxable year which includes a December 31, to an amount equal to $25,000 divided by the number of component members of such group on such December 31.

(iv) If a component member of the controlled group makes its income tax return on the basis of a 52–53-week taxable year, the principles of section 441(f)(2)(A)(ii) and §1.441–2 apply in determining the last day of such taxable year.

(3) *Definitions of controlled group of corporations and component member of controlled group.* For the purpose of this paragraph, the terms ''controlled group of corporations'' and ''component member'' of a controlled group of corporations shall have the same meaning assigned to those terms in section 1563 (a) and (b). For purposes of applying §1.1563–1(b)(2)(ii)(*c*), an electing small business corporation shall be treated as an excluded member whether or not it is subject to the tax imposed by section 1378.

(4) *Members of a controlled group filing a consolidated return.* If some component members of a controlled group join in filing a consolidated return pursuant to §1.1502–3(a)(3), and other component members do not join, then, unless a consent is timely filed apportioning the $25,000 amount among the group filing the consolidated return and the other component members of the controlled group, each component member of the controlled group (including each component member which joins in filing the consolidated return) shall be treated as a separate corporation for purposes of equally apportioning the $25,000 amount under subparagraph (2)(iii) of this paragraph. In that case, the tax liability limitation for the group filing the consolidated return is computed by substituting for the $25,000 amount under section 46(a)(3) the total amount apportioned to each component member that joins in filing the consolidated return. If the affiliated group filing the consolidated return and the other component members of the controlled group adopt an apportionment plan, the affiliated group shall be treated as a single member for the purpose of applying subparagraph (2)(i) of this paragraph. Thus, for example, only one consent executed by the common parent to the apportionment plan is required for the group filing the consolidated return. If

any component member of the controlled group which joins in the filing of the consolidated return is an organization to which section 593 applies or a cooperative organization described in section 1381(a), see paragraph (a)(3)(ii) of § 1.1502–3.

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

Example 1. At all times during 1976 Smith, an individual, owns all the stock of corporations X, Y, and Z. Corporation X files an income tax return on a calendar year basis. Corporation Y files an income tax return on the basis of a fiscal year ending June 30. Corporation Z files an income tax return on the basis of a fiscal year ending September 30. On December 31, 1976, X, Y, and Z are component members of the same controlled group. X, Y, and Z all consent to an apportionment plan in which the $25,000 amount is apportioned entirely to Y for its taxable year ending June 30, 1977 (Y's taxable year which includes December 31, 1976). Such consent is timely filed. For purposes of computing the credit under section 38, Y's tax liability limitation for its taxable year ending June 30, 1977, is so much of Y's tax liability as does not exceed $25,000, plus 50 percent of Y's tax liability in excess of $25,000. X's and Z's limitations for their taxable years ending December 31, 1976, and September 30, 1977, respectively, are equal to 50 percent of X's tax liability for 50 percent of Z's tax liability. On the other hand, if an apportionment plan is not timely filed, X's limitation would be so much of X's tax liability as does not exceed $8,333.33, plus 50 percent of X's liability in excess of $8,333.33, and Y's and Z's limitations would be computed similarly.

Example 2. At all times during 1976, Jones, an individual, owns all the outstanding stock of corporations P, Q, and R. Corporations Q and R both file returns for taxable years ending December 31, 1976. P files a consolidated return as a common parent for its fiscal year ending June 30, 1977, with its two wholly-owned subsidiaries N and O. On December 31, 1976, N, O, P. Q, and R are component members of the same controlled group. No consent to an apportionment plan is filed. Therefore, each member is apportioned $5,000 of the $25,000 amount ($25,000 divided equally among the five members). The tax liability limitation for the group filing the consolidated return (P, N, and O) for the year ending June 30, 1977 (the consolidated taxable year within which December 31, 1976, falls) is computed by using $15,000 instead of the $25,000 amount. The $15,000 is arrived at by adding together the $5,000 amounts apportioned to P, N, and O.

(q) *Rehabilitation percentage*—(1) *General rule*—(i) *In general.* Due to amendments made by the Tax Reform Act of 1986, different rules apply depending on when the property attributable to the qualified rehabilitated expenditures (as defined in § 1.48–12(c)) is placed in service. Paragraph (q)(1)(ii) of this section contains the general rule relating to property placed in service after December 31, 1986. Paragraph (q)(1)(iii) of this section contains rules relating to property placed in service before January 1, 1987. Paragraph (q)(1)(iv) of this section contains rules relating to property placed in service after December 31, 1986, that qualifies for a transition rule.

(ii) *Property placed in service after December 31, 1986.* Except as otherwise provided in paragraph (q)(1)(iv) of this section, in the case of section 38 property described in section 48(a)(1)(E) placed in service after December 31, 1986, the term ''rehabilitation percentage'' means—

(A) 10 percent in the case of qualified rehabilitation expenditures with respect to a qualified rehabilitated building other than a certified historic structure, and

(B) 20 percent in the case of qualified rehabilitation expenditures with respect to a certified historic structure.

(iii) *Property placed in service before January 1, 1987.* For qualified rehabilitation expenditures (as defined in § 1.48–12(c)) with respect to property placed in service before January 1, 1987, section 46(b)(4)(A) as in effect prior to the enactment of the Tax Reform Act of 1986 provided for a three-tier rehabilitation percentage. The applicable rehabilitation percentage for such expenditures depends on whether the qualified rehabilitated building is a ''30-year building,'' a ''40-year building,'' or a certified historic structure (as defined in section 48(g)(3) and § 1.48–12(d)(1)). The rehabilitation percentage for such qualified rehabilitation expenditures incurred with respect to a qualified rehabilitated building is 15 percent to the extent that the building is a 30-year building (*i.e.*, at least 30 years, but less than 40 years, has elapsed between the date the physical work on the rehabilitation began and the date the building was first placed in service), 20 percent to the extent that the building is a 40-year building (*i.e.*, at least 40 years has so elapsed), and 25 percent for certified historic structures, regardless of age. See paragraph (q)(2)(ii) of this section for rules concerning buildings to which additions have been added.

(iv) *Property placed in service after December 31, 1986, that qualifies under the transition rules.* In the case of section 38 property described in section 48(a)(1)(E) placed in service after December 31, 1986, and to which the amendments made by section 251 of the Tax Reform Act of 1986 do not apply because the transition rules in section 251(d) of that Act and §1.48–12(a)(2)(iv)(B) or (C) apply, the rehabilitation percentage for a ''30-year building'' (within the meaning of paragraph (q)(1)(iii) of this section) shall be 10 percent, the rehabilitation percentage for a ''40-year building'' (within the meaning of paragraph (q)(1)(iii) of this section) shall be 13 percent, and the rehabilitation percentage for a certified historic structure shall be 25 percent.

(2) *Special rules*—(i) *Moved buildings.* With respect to paragraph (q)(1)(ii) of this section, §1.48–12(b)(5) provides that a building (other than a certified historic structure) is not a qualified rehabilitated building unless it has been at the location where it is being rehabilitated since January 1, 1936. In addition, for purposes of paragraph (q)(1) (iii) and (iv) of this section, a building is not a ''30-year building'' unless it has been at the location where it is being rehabilitated for the thirty-year period immediately preceding the beginning of the rehabilitation process, and is not a ''40-year building'' unless it has been at the location where it is being rehabilitated for the forty-year period immediately preceding the beginning of the rehabilitation process.

(ii) *Building to which additions have been added*—(A) *Property placed in service after December 31, 1986.* For purposes of paragraph (q)(1)(ii) of this section, if part of a building meets the definition of a qualified rehabilitated building, and part of the building does not meet the definition of a qualified rehabilitated building because such part is an addition that was placed in service after December 31, 1935, the qualified rehabilitation expenditures made to the building must be allocated to the pre-1936 portion of the building and the post-1935 portion of the building using the principles in §1.48–12(c)(10)(ii). Qualified rehabilitation expenditures attributable to the post-1935 addition shall not qualify for the 10 percent rehabilitation percentage.

(B) *Property placed in service before January 1, 1987, and property qualifying for a transitional rule.* For purposes of paragraphs (q)(1) (iii) and (iv) of this section, if part of a building meets the definition of a ''40-year building'' and part of the building is an addition that was placed in service less than forty years before physical work on the rehabilitation began but more than thirty years before such date, then the qualified rehabilitation expenditures made to the building shall be allocated between the forty year old portion of the building and the thirty year old portion of the building, and a 20 percent rehabilitation percentage shall be applied to the forty year old portion of the building and a 15 percent rehabilitation percentage shall be applied to the thirty year old portion. This allocation shall be made using the principles in §1.48–12(c)(10)(ii). If an allocation cannot be made between the expenditures to the forty year old portion of the building and the thirty year old portion of the building, then the building will be considered to be a 30-year building. Furthermore, for purposes of this paragraph (q), a building (other than a certified historic structure) is not a qualified rehabilitated building to the extent of that portion of the building that is less than 30 years old. If rehabilitation expenditures are incurred with respect to an addition to a qualified rehabilitated building, but the addition is not considered to be part of the qualified rehabilitated building because the addition does not meet the age requirement in section 48(g)(1)(B) (as in effect prior to its amendment by the Tax Reform Act of 1986) and §1.48–12(b)(4)(i)(B), then no rehabilitation percentage will be applied to the expenditures attributable to the rehabilitation of the addition. Thus, for purposes of paragraphs (q)(1) (iii) and (iv) of this section, it may be necessary to allocate rehabilitation expenditures incurred with respect to a building between the original portion of the building and the addition.

(iii) *Mixed-use buildings.* If qualified rehabilitation expenditures are incurred for property that is excluded from section 38 property described in section 48(a)(1)(E) (because, for example, they are made with respect to a portion of the building used for lodging within the meaning of section 48(a)(3) and §1.48–1(h)), an allocation of the expenditures must be made between the expenditures that result in an addition to basis that is section 38 property and the expenditures that result in an addition to basis that is excluded from the definition of section 38 property since the rehabilitation percentage is applicable only to section 38 property. These allocations should be made using the principles contained in §1.48–12(c)(10)(ii).

(3) *Regular and energy percentages not to apply.* The regular percentage and the energy percentage shall not apply to that portion of the basis of any building that is attributable to qualified rehabilitation expenditures (as defined in §1.48–12(c)).

(4) *Effective date.* The rehabilitation percentage is applicable only to qualified rehabilitation expenditures (as defined in §1.48–12(c)). For rules relating to applicability of the regular percentage to qualified rehabilitation expenditures (as defined in §1.48–11(c)), see §1.48–11.

[T.D. 6731, 29 FR 6064, May 8, 1964]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting §1.46–1, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at *www.fdsys.gov.*

§1.46–2 Carryback and carryover of unused credit.

(a) *Effective date.* This section is effective for taxable years beginning after December 31, 1975. For taxable years beginning before January 1, 1976, see 26 CFR 1.46–2 (Rev. as of April 1, 1979).

(b) *In general.* Under section 46(b)(1), unused credit may be carried back and carried over. Carrybacks and carryovers of unused credit are taken into account in determining the amount of credit available and the credit allowed for the taxable years to which they may be carried. In general, the application of the rules of this section to regular and ESOP credits are separate from their application to nonrefundable energy credits. For example, the limitations on carrybacks and carryovers of unused nonrefundable energy credit under section 46(b) (2) and (3), respectively, differ in amount from the limitations on the regular and ESOP credits because the tax liability limitations for those credits differ. See §1.46–1(h). For a further example, see the special ordering rule in §1.46–1(m). Section 46(b) does not apply to the refundable energy credit.

(c) *Unused credit.* If carryovers and credit earned (as defined in §1.46–1(c)(1)) exceed the applicable tax liability limitation, the excess attributable to credit earned is an unused credit. The taxable year in which an unused credit arises is referred to as the ''unused credit year''.

(d) *Taxable years to which unused credit may be carried.* An unused credit is a carryback to each of the 3 taxable years preceding the unused credit year and a carryover to each of the 7 taxable years succeeding the unused credit year. An unused credit must be carried first to the earliest of those 10 taxable years. An unused credit then must be carried to each of the other 9 taxable years (in order of time) to the extent that the unused credit was not absorbed during a prior taxable year because of the limitations under section 46(b) (2) and (3).

(e) *Special rule for pre-1971 years*—(1) *In general.* For unused credit years ending before January 1, 1971, unused credit is allowed a 10-year carryover rather than the 7-year carryover. The principles of paragraph (d) of this section apply to this 10-year carryover.

(2) *Cross reference.* For limitations on the taxable years to which unused credit from pre-1971 credit years may be carried, see paragraph (g) of this section.

(f) *Limitations on carrybacks.* Under the FIFO rule to section 46(a)(1), carryovers and credit earned are applied against the tax liability limitation before carrybacks. Thus, carrybacks to a taxable year may not exceed the amount by which the applicable tax liability limitation for that year exceeds the sum of carryovers to and credit earned for that year. Carrybacks from an unused credit year are applied against tax liability before carrybacks from a later unused credit year. To the extent an unused credit cannot be carried back to a particular preceding taxable year, the unused credit must be carried to the next succeeding taxable year to which it may be carried.

(g) *Limitations on carryovers*—(1) *General rule*. Carryovers to a taxable year may not exceed the applicable tax liability limitation for that year. Carryovers from an unused credit year are applied before carryovers from a later unused credit year.

(2) *Exception*. A 10-year carryover from a pre-1971 unused credit year may, under certain circumstances, be postponed to prevent a later-earned 7-year carryover from expiring. This exception does not extend the 10-year carryover period for pre-1971 unused credit. See section 46(b)(1)(D).

(h) *Examples*. The following examples illustrate paragraphs (a) through (g) of this section.

Example 1. (a) Corporation M is organized on January 1, 1977 and files its income tax return on a calendar year basis. Assume the facts set forth in columns (1) and (2) of the following table. The determination of the regular credit allowed for each of the taxable years indicated is set forth in the remaining portions of the table.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	Credit available	Tax liability	Percent	Tax liability limitation (remaining from col. (6) on preceding line)	Credit allowed (lower of (1) or (4))	Remaining tax liability limitation ((4)–(5))	Unused credit ((1)–(5)) or (amount absorbed)
1977:							
A. Credit earned	$20,000	$45,000	50	$35,000	$20,000	$15,000	0
B. Carryback from 1978	*15,000			[15,000]	15,000		
1978:							
A. Credit earned	80,000	55,000	50	40,000	40,000	0	$20,000
Carryback to 1977							(*15,000)
Carryover to 1979							(*5,000)
1979:							
A. Carryover from 1978	*5,000	50,000	60	40,000	6,000	35,000	
B. Credit earned	50,000			[35,000]	35,000	0	15,000
Carryover to 1980							(*15,000)
1980:							
A. Carryover from 1979	*15,000	55,000	70	46,000	15,000	31,000	
B. Credit earned	25,000			[31,000]	25,000	6,000	0

*For line "A" each year: Lesser of (1) tax liability or (2) $25,000 + (percentage in col. (3) × [col. (2) − $25,000]). See, § 1.46–1(h). For other lines: Amount in col. (6) on preceding line.

Example 2. (a) Assume the same facts as in *Example 1* except for 1979 M earns a $35,000 nonrefundable energy credit. The following table shows the determinations for each year.

	(1)	(2)		(3)	(4)	(5)	(6)	(7)
		Tax liability						
	Credit available	(a) Regular	(b) Energy ((2)(a)–(5)(R))	Percent	Tax liability limitation* (remaining from col. (6) on preceding line)	Credit allowed (lower of (1) or (4))	Remaining tax liability limitation ((4)–(5))	Unused credit ((1)–(5)) or (amount absorbed)
1977:								
Regular:								
A. Credit earned	$20,000	$45,000		50	$35,000	$20,000R	$15,000	0
B. Carryback from 1978	*15,000				[15,000]	15,000R	0	
1978:								
Regular:								
A. Credit earned	60,000	55,000		50	40,000	40,000R	0	$20,000
Carryback to 1977								(*15,000)

	(1)	(2)		(3)	(4)	(5)	(6)	(7)
	Credit available	Tax liability		Percent	Tax liability limitation* (remaining from col. (6) on preceding line)	Credit allowed (lower of (1) or (4))	Remaining tax liability limitation ((4)–(5))	Unused credit ((1)–(5)) or (amount absorbed)
		(a) Regular	(b) Energy ((2)(a)–(5)(R))					
Carryover to 1979	....	....	....	....	....	....	....	(*5,000)
Energy:								
A. Carryback from 1979	*15,000	....	$15,000	100	15,000	15,000E	0	
1979:								
Regular:								
A. Carryover from 1978	*5,000	50,000	....	60	40,000	5,000R	35,000	
B. Credit earned	50,000	....	....	....	[35,000]	35,000R	0	15,000
Carryover to 1980	....	....	....	....	....	....	....	(*15,000)
Energy:								
A. Credit earned	35,000	....	10,000	100	10,000	10,000E	0	25,000
Carryback to 1978	....	....	....	....	....	....	....	(*15,000)
Carryover to 1980	....	....	....	....	....	....	....	(*10,000)
1980:								
Regular:								
A. Carryover from 1979	*15,000	55,000	....	70	46,000	15,000R	31,000	
B. Credit earned	25,000	....	....	....	[31,000]	25,000R	6,000	0
Energy:								
A. Carryover from 1979	*10,000	....	15,000	100	15,000	10,000E	5,000	

*See footnote to the chart in *Example 1.*

(b) Although, in general, a nonrefundable energy credit may be carried back to taxable years ending before October 1, 1978, in this example the unused nonrefundable energy credit from 1979 may not be absorbed in 1977. The 1977 tax liability limitation for the nonrefundable energy credit is the same as it is for the regular credit, reduced by regular credit previously allowed for 1977. See §§1.46–1(h)(3) and 1.46–1(m).

Example 3. (a) Assume the same facts as in *Example 2* except M has regular credit of $37,000 for 1981 and M's tax liability for 1981 is $32,500. The determinations for 1980 and 1981 are set forth in the following table.

	(1)	(2)		(3)	(4)	(5)	(6)	(7)
	Credit available	Tax liability		Percent	Tax liability limitation* (remaining from col. (6) on preceding line)	Credit allowed (lower of (1) or (4))	Remaining tax liability limitation ((4)–(5))	Unused credit ((1)–(5)) or (amount absorbed)
		(a) Regular	(b) Energy ((2)–(5)(R))					
1979 (restated):								
Energy:								
To be carried over	....	....	....	....	....	....	....	$10,000
Carryover to 1980	....	....	....	....	....	....	....	(*9,000)
Carryover to 1981	....	....	....	....	....	....	....	(*1,000)
1980 (restated):								
Regular:								
A. Carryover from 1979	$15,000	$55,000	....	70	$46,000	$15,000R	$31,000	
B. Credit earned	*25,000	....	....	....	[31,000]	25,000R	6,000	0
C. Carryback from 1981	*6,000	....	....	....	[6,000]	6,000R	0	
Energy:								
A. Carryover from 1979	*9,000	....	$9,000	100	9,000	9,000E		
1981: Regular:								
A. Credit earned	37,000	32,500	....	80	31,000	31,000R	0	6,000
Carryback to 1980	....	....	....	....	....	....	....	(*6,000)
Energy:								
A. Carryover from 1979	*1,000	....	1,500	100	1,500	1,000E	500	0

*See footnote to chart under *Example 1.*

(b) Allowance of the regular carryback in 1980 from 1981 requires that the computations for 1980 be restated. The energy tax liability limitation for 1980 is reduced from $15,000 (as determined in *Example 2*) to $9,000. Thus, $1,000 of the $10,000 energy credit allowed for 1980 is displaced by the regular carryback. That amount may not be carried back because there is no remaining energy tax liability limitation for the prior 3 years (see table in *Example 2*). It may be carried over to 1981 and allowed in full in that year.

(i) [Reserved]

(j) *Electing small business corporation.* A shareholder of an electing small business corporation (as defined in section 1371(b)) may not take into account unused credit of the corporation attributable to unused credit years for which the corporation was not an electing small business corporation. However, a taxable year for which the corporation is an electing small business corporation is counted as a taxable year for determining the taxable years to which that unused credit may be carried.

(k) *Periods of less than 12 months.* A fractional part of a year that is considered a taxable year under sections 441(b) and 7701(a)(23) is treated as a preceding or succeeding taxable year for determining under section 46(b) the taxable years to which an unused credit may be carried.

(l) *Corporate acquisitions.* For carryover of unused credits in the case of certain corporate acquisitions, see section 381(c)(23).

(Secs. 7805 (68A Stat. 917, 26 U.S.C. 7805) and 38(b) (76 Stat. 962, 26 U.S.C. 38))

[T.D. 7751, 46 FR 1679, Jan. 7, 1981]

§ 1.46–3 Qualified investment.

(a) *In general.* (1) With respect to any taxable year, the qualified investment of the taxpayer is the aggregate (expressed in dollars) of (i) the applicable percentage of the basis of each new section 38 property placed in service by the taxpayer during such taxable year, plus (ii) the applicable percentage of the cost of each used section 38 property placed in service by the taxpayer during such taxable year. With respect to any section 38 property, qualified investment means the applicable percentage of the basis (or cost) of such property. Section 38 property placed in service by the taxpayer during the taxable year includes the taxpayer's share of the basis (or cost) of section 38 property placed in service by a partnership in the taxable year of such partnership ending with or within the taxpayer's taxable year. In the case of a shareholder of an electing small business corporation (as defined in section 1371(b)), or a beneficiary of an estate or trust, see §§ 1.48–5 and 1.48–6, respectively, for apportionment of the basis (or cost) of section 38 property placed in service by such corporation, estate, or trust. For the definitions of new section 38 property and used section 38 property, see §§ 1.48–2 and 1.48–3, respectively. *See* § 1.46–5 for special rules for progress expenditure property.

(2) The basis (or cost) of section 38 property placed in service during a taxable year shall not be taken into account in determining qualified investment for such year if such property is disposed of or otherwise ceases to be section 38 property during such year, except where § 1.47–3 applies. Thus, if individual A places in service during a taxable year section 38 property and later in the same year sells such property, the basis (or cost) of such property shall not be taken into account in determining A's qualified investment. On the other hand, if A places in service section 38 property during a taxable year and dies later in the same year, the basis (or cost) of such property would be taken into account in computing qualified investment. Similarly, if section 38 property is destroyed by fire in the same year in which it is placed in service and paragraph (h) of this section applies to reduce the basis (or cost) of replacement property, the basis (or cost) of the destroyed property would be taken into account in computing qualified investment. In order to determine whether section 38 property is disposed of or otherwise ceases to be section 38 property see § 1.47–2.

(3) Qualified investment is reduced in the case of property which is ''public utility property'' (see paragraph (h) of this section), and in the case of property of organizations to which section 593 applies, regulated investment companies or real estate investment trusts subject to taxation under subchapter

M, chapter 1 of the Code, and cooperative organizations described in section 1381(a) (see §1.46–4).

(b) *Applicable percentage.* The applicable percentage to be applied to the basis (or cost) of property is 33⅓ percent if the estimated useful life of the property is 3 years or more but less than 5 years; 66⅔ percent if the estimated useful life is 5 years or more but less than 7 years; or 100 percent if the estimated useful life is 7 years or more. In the case of property which is not described in section 50, the preceding sentence shall be applied by substituting ''4 years'' for ''3 years'', ''6 years'' for ''5 years'', and ''8 years'' for ''7 years''. The provisions of this paragraph may be illustrated by the following example:

Example. Corporation Y acquires and places in service during 1972 the following new and used section 38 properties:

Property	Estimated useful life (years)	Basis (or cost)
A (new)	4	$60,000
B (new)	10	90,000
C (new)	6	150,000
D (used)	3	30,000

Corporation Y's qualified investment for 1972 is $220,000 determined in the following manner:

Property	Basis (or cost)	Applicable percentage	Qualified investment
A	$60,000	33⅓	$20,000
B	90,000	100	90,000
C	150,000	66⅔	100,000
D	30,000	33⅓	10,000
Total			220,000

(c) *Basis or cost.* (1) The basis of any new section 38 property shall be determined in accordance with the general rules for determining the basis of property. Thus, the basis of property would generally be its cost (see section 1012), unreduced by the adjustment to basis provided by section 48(g)(1) with respect to property placed in service before January 1, 1964, and any other adjustment to basis, such as that for depreciation, and would include all items properly included by the taxpayer in the depreciable basis of the property, such as installation and freight costs. However, for purposes of determining qualified investment, the basis of new section 38 property constructed, reconstructed, or erected by the taxpayer shall not include any depreciation sustained with respect to any other property used in the construction, reconstruction, or erection of such new section 38 property. (See paragraph (b)(4) of §1.48–1.) If new section 38 property is acquired in exchange for cash and other property in a transaction described in section 1031 in which no gain or loss is recognized, the basis of the newly acquired property for purposes of determining qualified investment would be equal to the adjusted basis of the other property plus the cash paid. See §1.48–4 for the basis of property to a lessee where the lessor has elected to treat such lessee as a purchaser.

(2) The cost of any used section 38 property shall be determined in accordance with paragraph (b) of §1.48–3. However, the aggregate cost of used section 38 property which may be taken into account in any taxable year in computing qualified investment cannot exceed $50,000 (see paragraph (c) of §1.48–3).

(3) For reduction in the basis (or cost) of certain property which replaces other property which was destroyed or damaged by fire, storm, shipwreck, or other casualty, or which was stolen, see paragraph (h) of this section.

(d) *Placed in service.* (1) For purposes of the credit allowed by section 38, property shall be considered placed in service in the earlier of the following taxable years:

(i) The taxable year in which, under the taxpayer's depreciation practice, the period for depreciation with respect to such property begins; or

(ii) The taxable year in which the property is placed in a condition or state of readiness and availability for a specifically assigned function, whether in a trade or business, in the production of income, in a tax-exempt activity, or in a personal activity.

Thus, if property meets the conditions of subdivision (ii) of this subparagraph in a taxable year, it shall be considered placed in service in such year notwithstanding that the period for depreciation with respect to such property begins in a succeeding taxable year because, for example, under the taxpayer's depreciation practice such property is accounted for in a multiple asset account and depreciation is computed under an ''averaging convention'' (see § 1.167(a)–10), or depreciation with respect to such property is computed under the completed contract method, the unit of production method, or the retirement method.

(2) In the case of property acquired by a taxpayer for use in his trade or business (or in the production of income), the following are examples of cases where property shall be considered in a condition or state of readiness and availability for a specifically assigned function:

(i) Parts are acquired and set aside during the taxable year for use as replacements for a particular machine (or machines) in order to avoid operational time loss.

(ii) Operational farm equipment is acquired during the taxable year and it is not practicable to use such equipment for its specifically assigned function in the taxpayer's business of farming until the following year.

(iii) Equipment is acquired for a specifically assigned function and is operational but is undergoing testing to eliminate any defects.

(iv) Reforestation expenditures (as defined in § 1.194–3(c)) are incurred during the taxable year in connection with qualified timber property (as defined in § 1.194–3(a)).

However, fruit-bearing trees and vines shall not be considered in a condition or state of readiness and availability for a specifically assigned function until they have reached an income-producing stage. Moreover, materials and parts acquired to be used in the construction of an item of equipment shall not be considered in a condition or state of readiness and availability for a specifically assigned function.

(3) Notwithstanding subparagraph (1) of this paragraph, property with respect to which an election is made under § 1.48–4 to treat the lessee as having purchased such property shall be considered placed in service by the lessor in the taxable year in which possession is transferred to such lessee.

(4)(i) The credit allowed by section 38 with respect to any property shall be allowed only for the first taxable year in which such property is placed in service by the taxpayer. The determination of whether property is section 38 property in the hands of the taxpayer shall be made with respect to such first taxable year. Thus, if a taxpayer places property in service in a taxable year and such property does not qualify as section 38 property (or only a portion of such property qualifies as section 38 property) in such year, no credit (or a credit only as to the portion which qualifies in such year) shall be allowed to the taxpayer with respect to such property notwithstanding that such property (or a greater portion of such property) qualifies as section 38 property in a subsequent taxable year. For example, if a taxpayer places property in service in 1963 and uses the property entirely for personal purposes in such year, but in 1964 begins using the property in a trade or business, no credit is allowable to the taxpayer under section 38 with respect to such property. See § 1.48–1 for the definition of section 38 property.

(ii) Notwithstanding subdivision (i) of this subparagraph, if, for the first taxable year in which property is placed in service by the taxpayer, the property qualifies as section 38 property but the basis of the property does not reflect its full cost for the reason that the total amount to be paid or incurred by the taxpayer for the property is indeterminate, a credit shall be allowed to the taxpayer for such first taxable year with respect to so much of the cost as is reflected in the basis of the property as of the close of such year, and an additional credit shall be allowed to the taxpayer for any subsequent taxable year with respect to the additional cost paid or incurred during such year and reflected in the basis of the property as of the close of such year. The estimated useful life used in computing each additional credit with respect to the property shall be the same as the estimated useful life used in computing the credit for the first taxable year in which the property was placed in service by the taxpayer. Assume, for example, that in 1964 X Corporation, a utility company which makes its return on the basis of a calendar year, enters into an agreement with Y Corporation, a builder, to construct certain utility facilities for a housing development built by Y. Assume further that part of the funds for the construction of the utility facilities is advanced by Y under a contract providing that X will repay the advances over a 10-year period in accordance with an agreed formula, after which no further amounts will be repayable by X even though the full amount advanced by Y has not been repaid. Assuming that the utility facilities are placed in service in 1964 and qualify as section 38 property, X is allowed a credit for 1964 with respect to its basis in the utility facilities at the close of 1964. For each succeeding taxable year X is allowed an additional credit with respect to the increase in the basis of the utility facilities resulting from the repayments to Y during such year.

(e) *Estimated useful life*—(1)(i) *In general*. With respect to assets placed in service by the taxpayer during any taxable year, for the purpose of computing qualified investment the estimated useful lives assigned to all assets which fall within a particular guideline class (within the meaning of Revenue Procedure 62–21) may be determined, at the taxpayer's option, under either subparagraph (2) or (3) of this paragraph. Thus, the taxpayer may assign estimated useful lives to all the assets falling in one guideline class in accordance with subparagraph (2) of this paragraph, and may assign estimated useful lives to all the assets falling within another guideline class in accordance with subparagraph (3) of this paragraph. See subparagraphs (4) and (5) of this paragraph for determination of estimated useful lives of assets not subject to subparagraph (2) or (3) of this paragraph.

(ii) Except as provided in subparagraph (7), this paragraph shall not apply to property described in section 50.

(2) *Class life system*. The taxpayer may assign to each asset falling within a guideline class, which is placed in service during the taxable year, the class life of the taxpayer for the guideline class for such year as determined under section 4, part II of Revenue Procedure 62–21. The preceding sentence may be applied to the assets falling within a guideline class irrespective of whether the taxpayer uses single asset accounts or multiple asset accounts in computing depreciation with respect to such assets and irrespective of whether the taxpayer chooses to have his depreciation allowance with respect to such assets examined under the rules provided in Revenue Procedure 62–21.

(3) *Individual useful life system*. (i) The taxpayer may assign an individual estimated useful life to each asset falling within a guideline class which is placed in service during the taxable year. With respect to the assets falling within the guideline class which are placed in single asset accounts for purposes of computing depreciation, the estimated useful life used for each asset for that purpose shall be used in determining qualified investment. With respect to the assets falling within the guideline class which are placed in multiple asset accounts (including a guideline class account described in Revenue Procedure 62–21) for which a group, classified, or composite rate is used in computing depreciation (or in single asset accounts for which an average life rate is used), the determination of estimated useful life for each asset in the account shall be made individually on the best estimate obtainable on the basis of all the facts and circumstances. The individual estimated useful lives used for all the assets placed in a multiple asset account, when viewed together, must be consistent with the group, classified, or composite life used for the account for purposes of computing depreciation.

(ii) In determining the individual estimated useful lives of assets similar in kind contained in a multiple asset account (or in single asset accounts for which an average life rate is used), the taxpayer may (*a*) assign to each of such assets the average useful life of such assets used for purposes of computing depreciation, or (*b*) assign separate lives to such assets based on the estimated range of years taken into consideration in establishing the average useful life. Thus, for example, if a taxpayer places nine similar trucks with an average estimated useful life of 7 years, based on an estimated range of 6 to 8 years (two trucks with a useful life of 6 years, five trucks with a useful life of 7 years, and two trucks with a useful life of 8 years), in a multiple asset account for which a group rate is used in computing depreciation, he may either assign a useful life of 6 years to two of the trucks, 7 years to five of the trucks, and 8 years to two of the trucks, or he may assign the average useful life of the trucks (7 years) to each of the nine trucks. Likewise, if a taxpayer places 100 similar telephone poles with an average useful life of 28 years, based on an estimated range of 3 to 40 years (two with a useful life of less than 4 years, three with a useful life of 4 to 6 years, four with a useful life of 6 to 8 years, and 91 with a useful life of more than 8 years), in a multiple asset account for which a group rate is used in computing depreciation, he may either assign useful lives corresponding to the estimated range of years of the poles (*i.e.*, a useful life of less than 4 years to two of the poles, etc.), or he may assign the average useful life of the poles (28 years) to each of the poles.

(iii) [Reserved]

(iv) For purposes of subdivision (ii) of this subparagraph, assets (other than "mass assets") shall not be considered as "similar in kind" in respect of other assets unless all such assets are substantially of the same value, nor shall used section 38 property be considered as "similar in kind" to new section 38 property.

(4) *Useful life of property subject to amortization*—(i) *In general*. In the case of property with respect to which amortization in lieu of depreciation is allowable, the term over which amortization deductions are taken shall be considered as the estimated useful life of such property.

(ii) *Qualified timber property*. In the case of qualified timber property (within the meaning of section 194(c)(1)), the normal growing period of such property shall be considered its estimated useful life.

(5) *Useful life of property subject to certain methods of depreciation*. If a taxpayer is using a method of depreciation, such as the unit of production or retirement method, which does not measure the useful life of the property in terms of years, he must estimate such useful life in years in order to compute his qualified investment.

(6) *Record requirements*. The taxpayer shall maintain sufficient records to determine whether section 47 (relating to certain dispositions, etc., of section 38 property) applies with respect to any asset.

(7) *Section 50 property*. (i) The provisions of this subparagraph and subparagraphs (4) and (6) of this paragraph shall apply to property which is described in section 50.

(ii) The estimated useful life of property for purposes of computing qualified investment shall be the useful life used or to be used by the taxpayer in computing the allowance for depreciation with respect to such property under section 167 for the taxable year in which the property is placed in service. Thus, if property is placed in service by a taxpayer in a taxable year but the period for depreciation with respect to such property does not begin until a succeeding taxable year (see paragraph (d)(1) of this section), the estimated useful life for purposes of computing qualified investment must be the estimated useful life that the taxpayer uses in computing the allowance for depreciation. See subdivision (iv) of this subparagraph for rules for determining the estimated useful life of property with respect to which the allowance for depreciation under section 167 is computed under the unit of production method, the income-forecast method, or any other method which does not measure the useful life of the property in terms of years.

(iii)(*a*) The estimated useful life of any section 38 property to which an election under section 167(m) applies shall be the asset depreciation period selected for such property under §1.167(a)–11(b)(4), whether or not such property constitutes mass assets (as defined in §1.47–1(e)(4)).

(*b*) The estimated useful life of any section 38 property to which an election under section 167(m) does not apply and which is placed in a multiple asset account for which a group, classified, or composite rate is used in computing depreciation (or in single asset accounts for which an average life rate is used) shall be determined individually for each asset on the best estimate obtainable on the basis of all the facts and circumstances. The individual estimated useful life for each asset placed in a multiple asset account (including a mass asset account) must be the same as the useful life of such asset used in determining the group, classified, or composite life for the account for purposes of computing depreciation. The individual estimated useful lives of assets similar in kind may be determined in accordance with subdivisions (ii) and (iv) of subparagraph (3) of this paragraph. In the case of mass assets, subdivision (iii) of subparagraph (3) of this paragraph shall apply.

(f) *Partnerships*—(1) *In general*. In the case of a partnership, each partner shall take into account separately, for his taxable year with or within which the partnership taxable year ends, his share of the basis of partnership new section 38 property and his share of the cost of partnership used section 38 property placed in service by the partnership during such partnership taxable year. Each partner shall be treated as the taxpayer with respect to his share of the basis of partnership new section 38 property and his share of the cost of partnership used section 38 property. The estimated useful life to each partner of such property shall be deemed to be the estimated useful life of the property in the hands of the partnership. Partnership section 38 property shall not, by reason of each partner taking his share of the basis or cost into account, lose its character as either new section 38 property or used section 38 property, as the case may be. For computation of each partner's qualified investment for the energy credit for a qualified intercity bus, see §1.48–9(q)(9)(iv).

(2) *Determination of partner's share*. (i) Each partner's share of the basis (or cost) of any section 38 property shall be determined in accordance with the ratio in which the partners divide the general profits of the partnership (that is, the taxable income of the partnership as described in section 702(a)(9)) regardless of whether the partnership has a profit or a loss for its taxable year during which the section 38 property is placed in service. However, if the ratio in which the partners divide the general profits of the partnership changes during the taxable year of the partnership, the ratio effective for the date on which the property is placed in service shall apply.

(ii) Notwithstanding subdivision (i) of this subparagraph, if all related items of income, gain, loss, and deduction with respect to any item of partnership section 38 property are specially allocated in the same manner and if such special allocation is recognized under section 704 (a) and (b) and paragraph (b) of §1.704–1, then each partner's share of the basis of such item of new section 38 property or the cost of such item of used section 38 property shall be determined by reference to such special allocation effective for the date on which the property is placed in service.

(iii) Notwithstanding subdivisions (i) and (ii) of this subparagraph, if with respect to a partnership's taxable year the conditions set forth in (*a*) through (*c*) of this subdivision are satisfied with respect to a partner, then such partner shall not take into account the basis (or cost) of any section 38 property placed in service by the partnership during such taxable year. The conditions referred to in the preceding sentence are:

(*a*) Such partner's interest in the general profits of the partnership during the taxable year is 5 percent or less;

(*b*) Under the partnership agreement, such partner will retire from the partnership during the taxable year or within 7 years after the end of such year; and

(*c*) The partnership agreement provides that the basis (or cost) of section 38 property placed in service by the partnership during the taxable year shall not be taken into account by a partner described in (*a*) and (*b*) of this subdivision.

Any basis (or cost) of section 38 property which is not taken into account by a partner because of the provisions of this subdivision shall be taken into account by the other partners in accordance with subdivision (i) of this subparagraph.

(3) *Examples*. This paragraph may be illustrated by the following examples:

Example 1. Partnership ABCD acquires and places in service on January 1, 1962, an item of new section 38 property, and acquires and places in service on September 1, 1962, another item of new section 38 property. The ABCD partnership and each of its partners reports income on the basis of the calendar year. Partners A, B, C, and D share partnership profits equally. Each partner's share of the basis of each new partnership section 38 property is 25 percent.

Example 2. Assume the same facts as in *Example 1* and the following additional facts: A dies on June 30, 1962, and B purchases A's interest as of such date. Each partner's share of the profits from January 1 to June 30 is 25 percent. From July 1 to December 31, B's share of the profits is 50 percent, and C and D's share of the profits is 25 percent each. For A's last taxable year (January 1 to June 30, 1962), A shall take into account 25 percent of the basis of the section 38 property placed in service on January 1. B shall take into account 25 percent of the basis of the section 38 property placed in service on January 1 and 50 percent of the basis of the section 38 property placed in service on September 1, C and D shall each take into account 25 percent of the basis of each new section 38 property placed in service by the partnership in 1962.

Example 3. Partnership MR is engaged in the business of renting soda fountain equipment and icemakers to restaurants. The partnership makes no elections under §1.48–4 to treat its lessees as having purchased such property. Under the terms of the partnership agreement, the income, gain or loss on disposition, depreciation, and other deductions attributable to the icemakers are specially allocated 70 percent to partner M and 30 percent to partner R. In all other respects M and R share profits and losses equally. If the special allocation with respect to the icemakers is recognized under section 704 (a) and (b) and paragraph (b) of §1.704–1, the basis (or cost) of the icemakers which qualify as partnership section 38 property shall be taken into account 70 percent by M and 30 percent by R. The basis (or cost) of partnership section 38 property not subject to the special allocation shall be taken into account equally by M and R.

Example 4. Assume the same facts as in *Example 3* and the following additional facts: During November 1962, the partnership, which reports its income on the basis of a fiscal year ending May 31, acquires and places in service two items which qualify as new section 38 property, an icemaker and a soda fountain. The icemaker has an estimated useful life of 8 years to the partnership and a basis of $1,000. The soda fountain has an estimated useful life of 6 years to the partnership and a basis of $600. Partner M also owns and operates a business as a sole proprietorship and reports income on the calendar year basis. During 1963, M acquires and places in service in his sole proprietorship a machine which qualifies as new section 38 property. This machine has an estimated useful life of 4 years and a basis of $300. M owns no interest in any other partnerships, electing small business corporations, estates, or trusts. M's total qualified investment for 1963 is $1,000, computed as follows:

Property	Estimated useful life	Basis	M's share of basis	Applicable percentage	Qualified investment
Partnership MR					
Icemaker	8	$1,000	$700	100	$700
Soda fountain	6	600	300	66⅔	200
Sole proprietorship					
Machine	4	300		33⅓	100
Total					1,000

(g) *Public utility property*—(1) *In general*—(i) *Scope of paragraph*. This paragraph only applies to property described in section 50. For rules relating to public utility property not described in section 50, see 26 CFR part 1, §1.46–3(g) (as revised April 1, 1977). This paragraph does not reflect amendments to section 46(c) made after enactment of the Revenue Act of 1971.

(ii) *Amount of qualified investment*. A taxpayer's qualified investment in section 38 property that is public utility property is 4/7 of the amount otherwise determined under this section.

(2) *Meaning and uses of certain terms*. For purposes of this paragraph—

(i) *Public utility property*. ''Public utility property'' is property used by a taxpayer predominantly in a trade or business that is a public utility activity and property that is nonregulated communication property.

(ii) *Public utility activity.* A ''public utility activity'' is any activity in which the goods or services described in section 46(c)(3)(B) (i), (ii), or (iii) are furnished or sold at regulated rates. If property is used by a taxpayer both in a public utility activity and in another activity, the characterization of such property is based on the predominant use of such property during the taxable year in which it is placed in service.

(iii) *Regulated rates.* A taxpayer's rates are ''regulated'' if they are established or approved on a rate-of-return basis. Rates regulated on a rate-of-return basis are an authorization to collect revenues that cover the taxpayer's cost of providing goods or services, including a fair return on the taxpayer's investment in providing such goods or services, where the taxpayer's costs and investment are determined by use of a uniform system of accounts prescribed by the regulatory body. A taxpayer's rates are not ''regulated'' if they are established or approved on the basis of maintaining competition within an industry, insuring adequate service to customers of an industry, or charging ''reasonable'' rates within an industry since the taxpayer is not authorized to collect revenues based on the taxpayer's cost of providing goods or services. Rates are considered to have been ''established or approved'' if a schedule of rates is filed with a regulatory body that has the power to approve such rates, even though the regulatory body takes no action on the filed schedule or generally leaves undisturbed rates filed by the taxpayer.

(iv) *Nonregulated communication property.* ''Nonregulated communication property'' is property that is clearly the same type of property (and is used by the taxpayer predominantly for the same type of communication purposes) as communication property, but it is used by the taxpayer predominantly in a trade or business that is not a public utility activity. For purposes of this paragraph (g)(2)(iv), of this section, communication property is property ordinarily used for communication purposes by persons who provide regulated telephone or microwave communication services described in section 46(c)(3)(B)(iii). The determination of whether property is clearly of this same type and is used predominantly for these same communication purposes as communication property is made on the basis of the facts and circumstances of each particular case, including the current state of technology in the communications industry and the range and type of services permitted or required to be provided by the regulated telephone and microwave communication industry. As of 1978, wires or cables used predominantly to distribute to subscribers the signals of one or more television broadcast stations or cablecast stations (such as in a CATV system) are not used for the same type of communication purposes as communication property. Communication property includes microwave transmission equipment, private communication equipment (other than land mobile radio equipment for which the operator must obtain a license from the Federal Communications Commission), private switchboard (PBX) equipment, communications terminal equipment connected to telephone networks, data transmission equipment, and communications satellites. Communication property does not include (as of 1978) computer terminals or facsimile reproduction equipment that is connected to telephone lines to transmit data. It also does not include office furniture stands for communication property, tools, repair vehicles, and similar property, even if such property is exclusively used in providing regulated telephone or microwave communication services.

(3) *Leased property.* Public utility property includes property which is leased to others by a taxpayer where the leasing of such property is part of the lessor's public utility activity. Thus, such leased property is public utility property even though the lessee uses such property in an activity which is not a public utility activity, and whether or not the lessor of such property makes a valid election under §1.48–4 to treat the lessee as having purchased such property for purposes of the credit allowed by section 38. Property leased by a lessor, where the leasing is not part of a public utility

activity, to a lessee who uses such property predominantly in a public utility activity is public utility property for purposes of computing the lessor's or lessee's qualified investment with respect to such property.

(4) *Property used in both the production or transmission of gas and the local distribution of gas.* (i) With respect to properties of a taxpayer engaged in both the production or transmission of gas and the local distribution of gas, section 38 property shall be considered as used predominantly in the trade or business of the furnishing or sale of gas through a local distribution system if expenditures for such property are chargeable to any of the following accounts under either the uniform system of accounts prescribed for natural gas companies (class A and class B) by the Federal Power Commission, effective January 1, 1961, or the uniform system of accounts for class A and B gas utilities adopted in 1958 by the National Association of Railroad and Utility Commissioners (or would be chargeable to any of the following accounts if the taxpayer used either of such systems):

(*a*) Accounts 360 through 363, inclusive (Local Storage Plant), or

(*b*) Accounts 374 through 387, inclusive (Distribution Plant).

(ii) If expenditures for section 38 property are chargeable (or would be chargeable) to any of the following accounts under either of the systems named in subdivision (i) of this subparagraph, the determination of whether or not such property is used predominantly in the trade or business of the furnishing or sale of gas through a local distribution system shall be made under all the facts and circumstances relating to the actual use of such property in the year such property is placed in service:

(*a*) Accounts 304 through 320, inclusive (Manufactured Gas Production Plant), or

(*b*) Accounts 389 through 399, inclusive (General Plant).

For example, if an office machine is used 55 percent of the time for billing customers of the taxpayer's local distribution system in the year in which it is placed in service, such office machine shall be considered as used predominantly in the trade or business of the furnishing or sale of gas through a local distribution system.

(5) *Certain submarine cable property.* In the case of any interest in a submarine cable circuit which is property described in section 50 used to furnish telegraph service between the United States and a point outside the United States of a taxpayer engaged in furnishing international telegraph service (if the rates for such furnishing have been established or approved by a governmental unit, agency, instrumentality, commission, or similar body described in subparagraph (2) of this paragraph), the qualified investment shall not exceed the qualified investment attributable to so much of the interest of the taxpayer in the circuit as does not exceed 50 percent of all interests in the circuit.

(h) *Certain replacement property.* (1)(i) If section 38 property is placed in service by the taxpayer to replace property (whether or not section 38 property) similar or related in service or use, which was destroyed or damaged before August 16, 1971, by fire, storm, shipwreck, or other casualty, or was stolen before such date, then for purposes of paragraph (a) of this section the basis (or cost) of the replacement section 38 property otherwise determined under paragraph (c) of this section shall be reduced by an amount equal to the lesser of—

(*a*) The amount of money, or the fair market value of other property, received as compensation, by insurance or otherwise, for the property which was destroyed, damaged, or stolen, or

(*b*) The adjusted basis of such destroyed, damaged, or stolen property (immediately before such destruction, damage, or theft).

(ii) For purposes of subdivision (i) of this subparagraph—

(*a*) Section 38 property placed in service after the due date (including extensions of time thereof) for filing the taxpayer's income tax return for the taxable year in which the other property was destroyed, damaged, or stolen shall not be considered as replacement section 38 property, and

(*b*) If the property which is destroyed, damaged, or stolen, is leased property, no other leased property shall be considered as replacement property with respect to the property destroyed, damaged, or stolen, in any case in which the lessor makes or made an election under section 48(d) (relating to election with respect to certain leased property) with respect to either the property destroyed, damaged, or stolen, the other leased property, or both.

(2) Subparagraph (1) of this paragraph shall not apply to replacement property if the reduction, under such subparagraph (1), in the basis (or cost) of such replacement property is less than the excess of—

(i) The qualified investment with respect to the destroyed, damaged, or stolen property, over

(ii) The recomputed qualified investment with respect to such property (determined under the principles of paragraph (a) of § 1.47–1).

(3) This paragraph may be illustrated by the following examples:

Example 1. (i) A acquired and placed in service on January 1, 1962, machine No. 1, which qualified as section 38 property, with a basis of $30,000 and an estimated useful life of 6 years. The amount of qualified investment with respect to such machine was $20,000. On January 2, 1963, machine No. 1 is completely destroyed by fire. On January 1, 1963, the adjusted basis of such machine in A's hands is $24,500. On November 1, 1963, A receives $23,000 in insurance proceeds as compensation for the destroyed machine, and on December 15, 1963, A acquires and places in service machine No. 2, which qualifies as section 38 property, with a basis of $41,000 and an estimated useful life of 6 years to replace machine No. 1.

(ii) Under subparagraph (1) of this paragraph, the $41,000 basis of machine No. 2 is reduced, for purposes of paragraph (a) of this section, by $23,000 (that is, the $23,000 insurance proceeds since such amount is less than the $24,500 adjusted basis of machine No. 1 immediately before it was destroyed) to $18,000 since such reduction (that is, $23,000) is greater than the $20,000 reduction in qualified investment which would be made if paragraph (a) of § 1.47–1 were to apply to machine No. 1 ($20,000 qualified investment less zero recomputed qualified investment).

Example 2. (i) The facts are the same as in *Example 1* except that on November 1, 1963, A receives only $19,000 in insurance proceeds as compensation for the destroyed machine.

(ii) The $41,000 basis of machine No. 2 is not reduced, for purposes of paragraph (a) of this section, under this paragraph since the $19,000 reduction which would have been made under this paragraph had it applied (that is, the $19,000 insurance proceeds since such amount is less than the $24,500 adjusted basis of machine No. 1 immediately before it was destroyed) is less than the $20,000 reduction in qualified investment which is made since paragraph (a) of § 1.47–1 applies to machine No. 1 ($20,000 qualified investment less zero recomputed qualified investment).

(Secs. 194 (94 Stat. 1989; 26 U.S.C. 194) and 7805 (68A Stat. 917, 26 U.S.C. 7805) of the Internal Revenue Code of 1954; secs. 38(b) (76 Stat. 963, 26 U.S.C. 38(b)), 48(l)(16) (94 Stat. 264, 26 U.S.C. 48(l)(16)), and 7805 (68A Stat. 917, 26 U.S.C. 7805)

[T.D. 6731, 29 FR 6068, May 8, 1964, as amended by T.D. 6931, 32 FR 14026, Oct. 10, 1967; T.D. 7203, 37 FR 17125, Aug. 25, 1972; T.D. 7602, 44 FR 17667, Mar. 23, 1979; T.D. 7927, 48 FR 55849, Dec. 16, 1983; T.D. 7982, 49 FR 39541, Oct. 9, 1984; T.D. 8183, 53 FR 6618, Mar. 2, 1988; T.D. 8474, 58 FR 25557, Apr. 27, 1993]

§ 1.46–4 Limitations with respect to certain persons.

(a) *Mutual savings institutions.* In the case of an organization to which section 593 applies (that is, a mutual savings bank, a cooperative bank, or a domestic building and loan association)—

(1) The qualified investment with respect to each section 38 property shall be 50 percent of the amount otherwise determined under § 1.46–3, and

(2) The $25,000 amount specified in section 46(a)(2), relating to limitation based on amount of tax, shall be reduced by 50 percent of such amount.

For example, if a domestic building and loan association places in service on January 1, 1963, new section 38 property with a basis of $30,000 and an estimated useful life of 6 years, its qualified investment for 1963 with respect to such property computed under § 1.46–3 is $20,000 (66⅔ percent of $30,000). However, under this paragraph such amount is reduced to $10,000 (50 percent of $20,000). If an organization to which section 593 applies is a member of an affiliated group (as defined in section 46(a)(5)), the $25,000 amount specified in section 46(a)(2) shall be reduced in accordance with the provisions of paragraph (f) of § 1.46–1 before such amount is further reduced under this paragraph.

(b) *Regulated investment companies and real estate investment trusts.* (1) In the case of a regulated investment company or a real estate investment trust subject to taxation under subchapter M, chapter 1 of the Code—

(i) The qualified investment with respect to each section 38 property otherwise determined under § 1.46–3, and

(ii) The $25,000 amount specified in section 46(a)(2), relating to limitation based on amount of tax,

shall be reduced to such person's ratable share of each such amount. If a regulated investment company or a real estate investment trust is a member of an affiliated group (as defined in section 46(a)(5)), the $25,000 amount specified in section 46(a)(2) shall be reduced in accordance with the provisions of paragraph (f) of § 1.46–1 before such amount is further reduced under this paragraph.

(2) A person's ratable share of the amount described in subparagraph (1)(i) and the amount described in subparagraph (1)(ii) of this paragraph shall be the ratio which—

(i) Taxable income for the taxable year, bears to

(ii) Taxable income for the taxable year plus the amount of the deduction for dividends paid taken into account under section 852(b)(2)(D) in computing investment company taxable income, or under section 857(b)(2)(B) (section 857(b)(2)(C), as then in effect, for taxable years ending before October 5, 1976) in computing real estate investment trust taxable income, as the case may be.

For purposes of the preceding sentence, taxable income means, in the case of a regulated investment company its investment company taxable income (within the meaning of section 852(b)(2)), and in the case of a real estate investment trust its real estate investment trust taxable income (within the meaning of section 857(b)(2)). In the case of a taxable year ending after October 4, 1976, real estate investment trust taxable income, for purposes of section 46(e) and this paragraph, is determined by excluding any net capital gain, and by computing the deduction for dividends paid without regard to capital gains dividends (as defined in section 857(b)(3)(C)). The amount of the deduction for dividends paid includes the amount of deficiency dividends (other than capital gains deficiency dividends) taken into account in computing investment company taxable income or real estate investment trust taxable income for the taxable year. See section 860(f) for the definition of deficiency dividends. For purposes of this paragraph only, in computing taxable income for a taxable year beginning before January 1, 1964, a regulated investment company or a real estate investment trust may compute depreciation deductions with respect to section 38 property placed in service before January 1, 1964, without regard to the reduction in basis of such property required under § 1.48–7.

(3) This paragraph may be illustrated by the following example:

Example. (i) Corporation X, a regulated investment company subject to taxation under section 852 of the Code which makes its return on the basis of the calendar year, places in service on January 1, 1964, section 38 property with a basis of $30,000 and an estimated useful life of 6 years. Corporation X's investment company taxable income under section 852(b)(2) is $10,000 after taking into account a deduction for dividends paid of $90,000.

(ii) Under this paragraph, corporation X's qualified investment for the taxable year 1964 with respect to such property is $2,000, computed as follows: (*a*) $20,000 (qualified investment under § 1.46–3), multiplied by (*b*) $10,000 (taxable income), divided by (*c*) $100,000 (taxable income plus the deduction for dividends paid). For 1964, the $25,000 amount specified in section 46(a)(2) is reduced to $2,500.

(c) *Cooperatives.* (1) In the case of a cooperative organization described in section 1381(a)—

(i) The qualified investment with respect to each section 38 property otherwise determined under § 1.46–3, and

(ii) The $25,000 amount specified in section 46(a)(2), relating to limitation based on amount of tax,

shall be reduced to such cooperative's ratable share of each such amount. If a cooperative organization described in section 1381(a) is a member of an affiliated group (as defined in section 46(a)(5)), the $25,000 amount specified in section 46(a)(2) shall be reduced in accordance with the provisions of paragraph (f) of § 1.46–1 before such amount is further reduced under this paragraph.

(2) A cooperative's ratable share of the amount described in subparagraph (1)(i) and the amount described in subparagraph (1)(ii) of this paragraph shall be the ratio which—

(i) Taxable income for the taxable year, bears to

(ii) Taxable income for the taxable year plus the sum of (*a*) the amount of the deductions allowed under section 1382(b), (*b*) the amount of the deductions allowed under section 1382(c), and (*c*) amounts similar to the amounts described in (*a*) and (*b*) of this subdivision the tax treatment of which is determined without regard to subchapter T, chapter 1 of the Code and the regulations thereunder.

Amounts similar to deductions allowed under section 1382 (b) or (c) are, for example, in the case of a taxable year of a cooperative organization beginning before January 1, 1963, the amount of patronage dividends which are excluded or deducted and any nonpatronage distributions which are deducted under section 522(b)(1). In the case of a taxable year of a cooperative organization beginning after December 31, 1962, such amounts are the amount of patronage dividends and nonpatronage distributions which are excluded or deducted without regard to section 1382 (b) or (c) because they are paid with respect to patronage occurring before 1963. For purposes of this paragraph only, in computing taxable income for a taxable year beginning before January 1, 1964, a cooperative may compute depreciation deductions with respect to section 38 property placed in service before January 1, 1964, without regard to the reduction in basis of such property required under §1.48–7.

(3) This paragraph may be illustrated by the following example:

Example. (i) Cooperative X, an organization described in section 1381(a) which makes its return on the basis of the calendar year, places in service on January 1, 1964, section 38 property with a basis of $30,000 and an estimated useful life of 6 years. Cooperative X's taxable income is $10,000 after taking into account deductions of $20,000 allowed under section 1382(b), deductions of $60,000 allowed under section 1382(c), and deductions of $10,000 allowed under section 522(b)(1)(B).

(ii) Under this paragraph, cooperative X's qualified investment for the taxable year 1964 with respect to such property is $2,000, computed as follows: (*a*) $20,000 (qualified investment under §1.46–3), multiplied by (*b*) $10,000 (taxable income), divided by (*c*) $100,000 (taxable income plus the sum of the deductions allowed under sections 1382(b), 1382(c), and 522(b)(1)(B)). For 1964, the $25,000 amount specified in section 46(a)(2) is reduced to $2,500.

(d) *Noncorporate lessors.* (1) In the case of a lease entered into after September 22, 1971, a credit is allowed under section 38 to a noncorporate lessor of property with respect to the leased property only if—

(i) Such property has been manufactured or produced by the lessor in the ordinary course of his business, or

(ii) The term of the lease (taking into account any options to renew) is less than 50 percent of the estimated useful life of the property (determined under §1.46–3(e)), and for the period consisting of the first 12 months after the date on which the property is transferred to the lessee the sum of the deductions with respect to such property which are allowable to the lessor solely by reason of section 162 (other than rents and reimbursed amounts with respect to such property) exceeds 15 percent of the rental income produced by such property.

In the case of property of which a partnership is the lessor, the credit otherwise allowable under section 38 with respect to such property to any partner which is a corporation shall be allowed notwithstanding the first sentence of this subparagraph. For purposes of this subparagraph, an electing small business corporation (as defined in section 1371) shall be treated as a person which is not a corporation. This paragraph shall not apply to property used by the taxpayer in his trade or business (other than the leasing of property) for a period of at least 24 months preceding the day on which any lease of such property is entered into.

(2) For purposes of subparagraph (1)(ii) of this paragraph, if at the time the lessor files his income tax return for the taxable year in which the property is placed in service, the lessor is unable to show that the more-than-15-percent test has been satisfied, then no credit may be claimed by the lessor on such return with respect to such property unless (i) taking into account the

lessor's obligations under the lease it is reasonable to believe that the more-than-15-percent test will be satisfied, and (ii) the lessor files a statement with his return from which it may be determined that he expects to satisfy the more-than-15-percent test. If the more-than-15-percent test is not satisfied with respect to the property, the taxpayer must file an amended return for the year in which the property is placed in service.

(3)(i) The more-than-15-percent test described in subparagraph (1)(ii) of this paragraph is based on the relationship of the expenses of the lessor relating to or attributable to the property to the gross income from rents of the taxpayer produced by the property. The test is applied with respect to such expenses and gross income as are properly attributable to the period consisting of the first 12 months after the date on which the property is transferred to the lessee. When more than one property is subject to a single lease and, pursuant to subparagraph (4) of this paragraph, the arrangement is considered to be a separate lease of each property, the test is applied separately to each such lease by making an apportionment of the payments received and expenses incurred with respect to each such property, considering all relevant factors. Such apportionment is made in accordance with any reasonable method selected and consistently applied by the taxpayer. For example, under subparagraph (4) of this paragraph, where a taxpayer leases an airplane which he owns to an airline along with a baggage truck, he is treated as having made two separate leases, one covering the airplane and one covering the baggage truck. Thus, the test will be applied by apportioning the related income and expenses between the two leases. Similarly, where a taxpayer leases a factory building erected by him containing section 38 property (machinery and equipment), the test will be applied to the taxpayer as though he had leased (to the lessee) the building and the section 38 property separately. Thus, the rental income and expenses are apportioned between the building and the section 38 property.

(ii) Only those deductions allowable solely by reason of section 162 are taken into account in applying the more-than-15-percent test. Hence, depreciation allowable by reason of section 167 (including amortization allowable in lieu of depreciation); interest allowable by reason of section 163; taxes allowable by reason of section 164; and depletion allowable by reason of section 611 are examples of deductions which are not taken into account in applying the test. Moreover, rents and reimbursed amounts paid or payable by the lessor are not taken into account notwithstanding that a deduction in respect of such rents or reimbursed amounts is allowable solely by reason of section 162. For purposes of this paragraph, a reimbursed amount is any expense for which the lessee or some other party is obligated to reimburse the lessor. Section 162 expenses paid or payable by any person other than the lessor are not taken into account unless the lessor is obligated to reimburse the person paying the expense. Further, if the lessee is obligated to pay to the lessor a charge for services which is separately stated or determinable, the expenses incurred by the lessor with respect to those services are not taken into account.

(iii) For purposes of the more-than-15-percent test, the gross income from rents of the lessor produced by the property is the total amount which is payable to the lessor by reason of the lease agreement other than reimbursements of section 162 expenses and charges for services which are separately stated or determinable. The fact that such amount depends, in whole or in part, on the sales or profits of the lessee or the performance of significant services by the lessor shall not affect the characterization of such amounts as gross income from rents for purposes of this paragraph. Gross income from rents also includes any taxes imposed on the lessor by local law but which are paid directly by the lessee on behalf of the lessor.

(4) For purposes of determining under this paragraph whether property is subject to a lease, the provisions of §1.57–3(d)(1) (relating to definition of a lease) shall apply. If a noncorporate

lessor enters into two or more successive leases with respect to the same or substantially similar items of section 38 property, the terms of such leases shall be aggregated and such leases shall be considered one lease for the purpose of determining whether the term of such leases is less than 50 percent of the estimated useful life of the property subject to such leases. Thus, for example, if an individual owns an airplane with an estimated useful life of 7 years and enters into three successive 3-year leases of such airplane, such leases will be considered to be one lease for a term of nine years for the purpose of determining whether the term of the lease is less than 3½ years (50 percent of the 7-year estimated useful life).

(5) The requirements of this paragraph shall not apply with respect to any property which is treated as section 38 property by reason of section 48(a)(1)(E).

(Sec. 860(e) (92 Stat. 2849, 26 U.S.C. 860(e)); sec. 860(g) (92 Stat. 2850, 26 U.S.C. 860(g)); and sec. 7805 (68A Stat. 917, 26 U.S.C. 7805))

[T.D. 6731, 29 FR 6071, May 8, 1964, as amended by T.D. 6958, 33 FR 9170, June 21, 1968; T.D. 7203, 37 FR 17126, Aug. 25, 1972; T.D. 7767, 46 FR 11262, Feb. 6, 1981; T.D. 7936, 49 FR 2105, Jan. 18, 1984; T.D. 8031, 50 FR 26697, June 28, 1985]

§ 1.46–5 Qualified progress expenditures.

(a) *Effective date.* This section applies to taxable years ending after December 31, 1974. This section reflects amendments to the Internal Revenue Code made only by the Tax Reduction Act of 1975, the Tax Reform Act of 1976, and the Revenue Act of 1978.

(b) *General rule.* Under section 46(d), a taxpayer may elect to take the investment credit for qualified progress expenditures (as defined in paragraph (g) of this section). In general, qualified progress expenditures are amounts paid (paid or incurred in the case of self-constructed property) for construction of progress expenditure property. The taxpayer must reasonably estimate that the property will take at least 2 years to construct and that the useful life of the property will be 7 years or more. Qualified progress expenditures may not be taken into account if made before the later of January 22, 1975, or the first taxable year to which an election under section 46(d) applies. In general, qualified progress expenditures are not allowed for the year property is placed in service, nor for the first year or any subsequent year recapture is required under section 47(a)(3). There is a percentage limitation on qualified progress expenditures for taxable years beginning before January 1, 1980. For a special rule relating to transfers of progress expenditure property, see paragraph (r) of this section.

(c) *Reduction of qualified investment.* Under section 46(c)(4), a taxpayer must reduce qualified investment for the year property is placed in service by qualified progress expenditures taken into account by that person or a predecessor. A ''predecessor'' of a taxpayer is a person whose election under section 46(d) carries over to the taxpayer under paragraph (o)(3) of this section.

(d) *Progress expenditure property.* Progress expenditure property is property constructed by or for the taxpayer, with a normal construction period of 2 years or more. The taxpayer must reasonably believe that the property will be new section 38 property with a useful life of 7 years or more when placed in service. Whether property is progress expenditure property is determined on the basis of facts know at the close of the taxable year of the taxpayer in which construction begins (or, if later, at the close of the first taxable year to which an election under section 46(d) applies). For purposes of this paragraph (d), property is constructed by or for the taxpayer only if it is built or manufactured from materials and component parts. Accordingly, progress expenditure property does not include property such as orchards, vineyards, livestock, or motion picture films or videotapes.

(e) *Normal construction period*—(1) *In general.* (i) The normal construction period is the period the taxpayer reasonably expects will be required to construct the property. The period begins on the date physical work on construction of the property commences and ends on the date the property is available to be placed in service. The normal construction period does not include, however, construction before

January 22, 1975, nor construction before the first day of the first taxable year for which an election under section 46(d) is in effect. Physical work on construction of property does not include preliminary activities such as planning, designing, preparing blueprints, exploring, or securing financing.

(ii) The determination of the time when physical work on construction commences is based on the facts and circumstances of each case. Physical work on construction of property may include the physical work done by a subcontractor on a component specifically designated as part of the property. Also, the commencement of physical work on construction may occur at a site different from the main site of construction of the property. For example, if a shipyard orders a turbine before it begins work on building a ship, the normal construction period of the ship is measured from the time the subcontractor commences physical work on construction of the turbine (if it is normal for such work to precede the work of the main contractor).

(iii) Generally, physical work on construction does not include physical activity that is not necessary to complete construction of the property, nor does it include physical work on construction of a building or other property that will not be new section 38 property when placed in service. Physical work on construction also does not include research and development activities in a laboratory or experimental setting.

(iv) The normal construction period of property ends on the date it is expected the property will be available to be placed in service. Property is considered available to be placed in service when construction is completed and the property is available for delivery to the site of its assigned function. It is not necessary that property be in a state of readiness for a specifically assigned function. Nor is it necessary that it actually be delivered to the site of its assigned function.

(2) *Estimates.* Taxpayers should refer to normal industry practice in estimating the normal construction period of particular items. A different period may be used if special circumstances exist making it impractical to make the estimate on the basis of normal industry practice. The estimate must be based on information available at the close of the taxable year in which physical work on construction of the property begins, or, if later, at the close of the first taxable year for which an election under section 46(d) is in effect for the taxpayer. If the estimate is reasonable when made, the actual time it takes to complete the work is, in general, irrelevant in determining whether property is progress expenditure property. However, if there is a significant error in estimating the normal construction period, it may be evidence that the estimate was unreasonable when made. For taxable years ending after April 1, 1988, a taxpayer not relying or normal industry practice to estimate the normal construction period of particular property must attach to the tax return for the taxable year in which physical work on construction of the property begins (or, if later, the first taxable year for which an election under section 46(d) is in effect) a statement of the basis relied upon in estimating the normal construction period of the property.

(3) *Integrated unit.* (i) In determining whether property has a normal construction period of 2 years or more, property that will be placed in service separately is to be considered separately. For example, if two ships are contracted for at the same time, each ship is considered separately under this paragraph. However, for property that will be placed in service as an integrated unit, the taxpayer must determine the normal construction period of the integrated unit. If the normal construction period of the integrated unit is 2 years or more, the normal construction period of each item of new section 38 property that is a part of the integrated unit is considered to be 2 years or more. Thus, the normal construction period of an integrated unit may be 2 years or more even if no part of the unit has a normal construction period of 2 years or more.

(ii) Property is part of an integrated unit only if the operation of that item is essential to the performance of the function to which the unit is assigned. Property essential to the performance of the function to which the unit is assigned includes property the use of which is significantly connected to that function and which effects the safe, proper, or efficient performance of the unit. Generally, property must be placed in service at the same time to be considered part of the same integrated unit. Properties are not an integrated unit, however, solely because they are to be placed in service at the same time.

(iii) The normal construction period for an integrated unit begins on the date the normal construction period of the first item of new section 38 property that is part of the unit begins. It is not necessary that physical work commence at the main construction site of the integrated unit.

The period ends on the date the last item of new section 38 property that is part of that unit is available to be placed in service. Property that is not new section 38 property, such as a building, is not considered part of an integrated unit for purposes of determining the normal construction period of that unit. For example, if a manufacturing plant has a normal construction period of two years or more but the equipment (*i.e.*, new section 38 property) to be installed in the plant has a normal construction period of less than two years, the plant and the equipment do not constitute an integrated unit with a construction period of two years or more and the equipment is not progress expenditure property.

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

Example 1. On July 1, 1974, corporation X begins physical work on construction of a machine with an estimated useful life when placed in service of more than 7 years. For its taxable year ending June 30, 1975, X makes an election under section 46(d). For purposes of determining on June 30, 1975, whether the machine is ''progress expenditure property'', the normal construction period is treated as having begun on January 22, 1975. Thus, the machine will be considered to be progress expenditure property on June 30, 1975, only if the estimated time required to complete construction after June 30 is at least 18 months and 22 days (*i.e.*, 2 years less the period January 22, 1975, through June 30, 1975).

Example 2. (i) Corporation X constructs a pipeline in two sections and simultaneously begins physical work on construction of each section on January 1, 1976. One section extends from city M to city N. The other extends from city N to city O. Oil will be transferred to storage tanks at both city N and city O. Corporation X also begins construction on January 1, 1976, of a pumping station necessary to the operation of the pipeline from city M to city N. Construction of a pumping station necessary to the operation of the pipeline from city N to city O begins on June 30, 1977. For 1976, corporation X makes an election under section 46(d).

(ii) The section of pipeline from city M to city N and the associated pumping station will be available to be placed in service on January 1, 1977. Construction of the section of the pipeline from city N to city O will be completed on June 30, 1977. However, that section of the pipeline will not be available to be placed in service until completion of the associated pumping station on January 1, 1978.

(iii) The section of pipeline from city M to city N and the section from city N to city O must be considered separately in determining the normal construction period of the property. Each section will be placed in service separately. However, each section of the pipeline and the associated pumping station may be considered an integrated unit. The pumping stations are essential to the operation of each section of pipeline. Each section of pipeline and the associated pumping station are placed in service at the same time.

(iv) The section of pipeline from city M to city N and the associated pumping station are not progress expenditure property, because the normal construction period of that unit is only 1 year (January 1, 1976 to January 1, 1977).

(v) The section of pipeline from city N to city O and the associated pumping station are progress expenditure property, because the normal construction of that integrated unit is 2 years (January 1, 1976 to January 1, 1978). It is immaterial that neither the construction period of that section of pipeline (January 1, 1976 to June 30, 1977) nor the construction period of the associated pumping station (June 30, 1977 to January 1, 1978) is 2 years.

(vi) Assume the pumping station associated with the pipeline from city N to city O includes backup pumping equipment that will be used only if the primary pumping equipment fails. The backup equipment is part of the integrated unit because it serves to effect the safe or efficient performance of the unit.

(f) *New section 38 property with a 7-year useful life*—(1) *In general*. The taxpayer must determine if property will be new section 38 property with a useful life of 7 years or more when placed in service. The determination must be made at the close of the taxable year in which construction begins or, if later, at the close of the first taxable year to which an election under section 46(d) applies for the taxpayer.

(2) *Determination based on reasonably expected use.* The determination of whether property will be ''new section 38 property'' (within the meaning of §§ 1.48–1 and 1.48–2 when placed in service must be based on the reasonably expected use of the property by the taxpayer. There is a presumption that property will be new section 38 property if it would be new section 38 property if placed in service by the taxpayer when the determination is made. For example, in determining if property is an integral part of manufacturing under section 48(a)(1)(B)(i), it will be presumed that property will be new section 38 property if the taxpayer is engaged in manufacturing when the determination is made. Also, significant steps taken to establish a trade or business will be evidence the taxpayer will be engaged in that trade or business when the property is placed in service.

(3) *Estimated useful life.* The determination of whether property will have an estimated useful life of 7 years or more when placed in service must be made by applying the principles of § 1.46–3(e). If the estimated useful life is less than 7 years when the property is actually placed in service, the credit previously allowed under section 46(d) must be recomputed under section 47(a)(3)(B).

(g) *Definition of qualified progress expenditures*—(1) *In general.* A taxpayer's qualified progress expenditures are the sum of qualified progress expenditures for self-constructed property (determined under paragraph (h) of this section), plus qualified progress expenditures for non-self-constructed property (determined under paragraph (j) of this section). Only amounts includible under § 1.46–3(c) in the basis of new section 38 property may be considered as qualified progress expenditures.

(2) *Excluded amounts.* Qualified progress expenditures do not include:

(i) In the case of non-self-constructed property, amounts incurred (whether or not paid)—

(A) Before the normal construction period begins, or

(B) Before the later of January 22, 1975, or the first day of the first taxable year for which an election under section 46(d) applies for the taxpayer;

(ii) In the case of self-constructed property, amounts chargeable to capital account—

(A) Before the normal construction period begins, or

(B) Before the later of January 22, 1975, or the first day of the first taxable year for which an election under section 46(d) applies for the taxpayer,

(See, however, section 46(d)(4)(A) and paragraph (h)(3)(i) of this section, relating to the time when amounts for component parts and materials are properly chargeable to capital account);

(iii) Expenditures with respect to particular property in the earlier of—

(A) The taxable year in which the property is placed in service, or

(B) The taxable year in which the taxpayer must recapture investment credit under section 47(a)(3) for the property or any subsequent year;

(iv) Expenditures for construction, reconstruction, or erection of property that is not section 38 property; or

(v) Amounts treated as an expense and deducted in the year paid or accrued.

(h) *Qualified progress expenditures for self-constructed property*—(1) *In general.* Qualified progress expenditures for self-constructed property (as defined in paragraph (k) of this section) are amounts properly chargeable to capital account in connection with that property. In general, amounts paid or incurred are chargeable to capital account if under the taxpayer's method of accounting they are properly includible in computing basis under § 1.46–3. Qualified progress expenditures for self-constructed property include both direct costs (e.g., labor, material, parts) and indirect costs (e.g., overhead, insurance) associated with construction of property to the extent those costs are properly chargeable to capital account.

(2) *Property partially non-self constructed.* If an item of property is self-constructed because more than half of the construction expenditures are

made directly by the taxpayer, then any expenditures (whether or not made directly by the taxpayer) for construction of that item of property are not subject to the limitations of section 46(d)(3)(B) and paragraph (j) of this section (relating to actual payment and progress in construction).

(3) *Time when amounts paid or incurred are properly chargeable to capital account.* (i) In general, expenditures for component parts and materials to be used in construction of self-constructed property are not properly chargeable to capital account until consumed or physically attached in the construction process. Component parts and materials that have been neither consumed nor physically attached in the construction process, but which have been irrevocably allocated to construction of that property are properly chargeable to capital account. Component parts and materials designed specifically for the self-constructed property may be considered irrevocably allocated to construction of that property at the time of manufacture of the component parts and materials. Component parts and materials not designed specifically for the property may be considered irrevocably allocated to construction at the time of delivery to the construction site if they would be economically impractical to remove. For example, pumps delivered to sites of construction of a tundra pipeline may be treated as irrevocably allocated to that pipeline on the date of delivery, even if they would be usable, but for their location on the tundra, in connection with other property. Component parts and materials are not to be considered irrevocably allocated to use in self-constructed property until physical work on construction of that property has begun (as determined under paragraph (e)(1)(ii) of this section). Mere bookkeeping notations are not sufficient evidence that the necessary allocation has been made.

(ii) A taxpayer's procedure for determining the time when an expenditure is properly chargeable to capital account for self-constructed property is a method of accounting. Under section 446(e), the method of accounting, once adopted, may not be changed without consent of the Secretary.

(4) *Records requirement.* The taxpayer shall maintain detailed records which permit specific identification of the amounts properly chargeable by the taxpayer during each taxable year to capital account for each item of self-constructed property.

(i) [Reserved]

(j) *Qualified progress expenditures for non-self-constructed property*—(1) *In general.* Qualified progress expenditures for non-self-constructed property (as defined in paragraph (l) of this section) are amounts actually paid by the taxpayer to another person for construction of the property, but only to the extent progress is made in construction. For example, such expenditures may include payments to the manufacturer of an item of progress expenditure property, payments to a contractor building progress expenditure property, or payments for engineering designs or blueprints that are drawn up during the normal construction period.

(2) *Property partially self-constructed.* If an item of property is non-self-constructed, but a taxpayer uses its own employees to construct a portion of the property, expenditures for construction of that portion are made directly by the taxpayer (see §1.46–5(h)(1)). Subject to the limitations of paragraph (g) of this section, those expenditures are qualified progress expenditures for non-self-constructed property if they satisfy the requirements of paragraphs (j) (4), (5), and (6) of this section. Wages actually paid to the taxpayer's employees are presumed to correspond to progress in construction. Other amounts, including expenditures for materials, parts, and overhead, must be actually paid, not borrowed from the payee, and attributable to progress made in construction by the taxpayer.

(3) *Property constructed by more than one person.* The percentage of completion limitation (as prescribed in paragraph (j)(6) of this section), including the presumption of ratable progress in construction, applies to an item of progress expenditure property as a whole. However, if several manufacturers or contractors do work in connection with the same property, the progress that each person makes toward completion of construction of the

property must be determined separately. Section 46(d)(3)(B) is then applied separately to amounts paid to each manufacturer or contractor based on each person's progress in construction. For example, assume the taxpayer contracts with three persons to build an item of equipment. The taxpayer contracts with A to build the frame, B to build the motor, and C to assemble the frame and motor. Assume each contract represents 33⅓ percent of the construction costs of the property. If, within the taxable year in which construction begins, A and B each complete 50 percent of the construction of the frame and motor, respectively, amounts paid to A during that taxable year not in excess of 16⅔ percent of the overall cost of the property, and amounts paid to B during that taxable year not in excess of 16⅔ percent of the overall cost of the property, are qualified progress expenditures. Section 46(d)(3)(B) does not apply, however, to persons, such as lower-tier subcontractors, that do not have a direct contractual relationship with the taxpayer. If, in the above example, A engages a subcontractor to construct part of the frame, section 46(d)(3)(B) is applied only to amounts paid by the taxpayer to A, B, and C, but the portion of construction completed by A during a taxable year includes the portion completed by A's subcontractor.

(4) *Requirement of actual payment.* Qualified progress expenditures for non-self-constructed property must be actually paid and not merely incurred. Amounts paid during the taxable year to another person for construction of non-self-constructed property may be in the form of money or property (e.g., materials). However, property given as payment may be considered only to the extent it will be includible under §1.46–3(c) in the basis of the non-self-constructed property when it is placed in service.

(5) *Certain borrowing disregarded.* Qualified progress expenditures for non-self-constructed property do not include any amount paid to another person (the ''payee'') for construction if the amount is paid out of funds borrowed directly or indirectly from the payee. Amounts borrowed directly or indirectly from the payee by any person that is related to the taxpayer (within the meaning of section 267) or that is a member of the same controlled group of corporations (as defined in section 1563(a)) will be considered borrowed indirectly from the payee. Similarly, amounts borrowed under any financing arrangement that has the effect of making the payee a surety will be considered amounts borrowed indirectly by the taxpayer from the payee.

(6) *Percentage of completion limitation.* (i) Under section 46(d)(3)(B)(ii), payments made in any taxable year may be considered qualified progress expenditures for non-self-constructed property only to the extent they are attributable to progress made in construction (percentage of completion limitation). Progress will generally be measured in terms of the manufacturer's incurred cost, as a fraction of the anticipated cost (as adjusted from year to year). Architectural or engineering estimates will be evidence of progress made in construction. Cost accounting records also will be evidence of progress. Progress will be presumed to occur not more rapidly than ratably over the normal construction period. However, the taxpayer may rebut the presumption by clear and convincing evidence of a greater percentage of completion.

(ii) If, after the first year of construction, there is a change in either the total cost to the taxpayer or the total cost of construction by another person, the taxpayer must recompute the percentage of completion limitation on the basis of revised cost. However, the recomputation will affect only amounts allowed as qualified progress expenditures in the taxable year in which the change occurs and in subsequent taxable years. The recomputation remains subject to the presumption of pro rata completion.

(iii) If, for any taxable year, the amount paid to another person for construction of an item of property under section 46(d)(3)(B)(i) exceeds the percentage of completion limitation in section 46(d)(3)(B)(ii), the excess is treated as an amount paid to the other person for construction for the succeeding taxable year. If for any taxable year the percentage of completion limitation for an item of property exceeds the amount paid to another during the taxable year for construction, the excess is added to the percentage of completion limitation for that property for the succeeding taxable year.

(iv) The taxpayer must maintain detailed records which permit specific identification of the amounts paid to each person for construction of each item of property and the percentage of construction completed by each person for each taxable year.

(7) *Example.* The following example illustrates paragraph (j)(6) of this section.

Example. (i) Corporation X agrees to build an airplane for corporation Y, a calendar year taxpayer. The airplane is non-self-constructed progress expenditure property. Physical work on construction begins on January 1, 1980. The normal construction period for the airplane is five years and the airplane is delivered and placed in service on December 31, 1984.

(ii) The cost of construction to corporation X is $500,000. The contract price is $550,000. Corporation Y makes a $110,000 payment in each of the years 1980 and 1981, an $85,000 payment in 1982, a $135,000 payment in 1983, and a $110,000 payment in 1984.

(iii) For 1980, corporation Y makes an election under section 46(d). Progress is presumed to occur ratably over the 5-year construction period, which is 20 percent in each year. Twenty percent of the contract price is $110,000. The percentage of completion limitation for each year, thus, is $110,000.

(iv) For each of the years 1980 and 1981, the $110,000 payments may be treated as qualified progress expenditures. The payments equal the percentage of completion limitation.

(v) For 1982, the $85,000 payment may be treated as a qualified progress expenditure, because it is less than the percentage of completion limitation. The excess of the percentage of completion limitation ($110,000) over the 1982 payment ($85,000) is added to the percentage of completion limitation for 1983. One hundred and ten thousand dollars minus $85,000 equals $25,000. Twenty-five thousand dollars plus $110,000 equals $135,000, which is the percentage of completion limitation for 1983.

(vi) For 1983, the entire $135,000 payment may be treated as a qualified progress expenditure. The payment equals the percentage of completion limitation for 1983.

(vii) For 1984, no qualified progress expenditures may be taken into account, because the airplane is placed in service in that year.

(viii) See example 2 of paragraph (r)(4) of this section for the result if Y sells its contract rights to the property on December 31, 1982.

(k) *Definition of self-constructed property*—(1) *In general.* Property is self-constructed property if it is reasonable to believe that more than half of the construction expenditures for the property will be made directly by the taxpayer. Construction expenditures made directly by the taxpayer include direct costs such as wages and materials and indirect costs such as overhead attributable to construction of the property. Expenditures for direct and indirect costs of construction will be treated as construction expenditures made directly by the taxpayer only to the extent that the expenditures directly benefit the construction of the property by employees of the taxpayer. Thus, wages paid to taxpayers's employees and expenditures for basic construction materials, such as sheet metal, lumber, glass, and nails, which are used by employees of the taxpayer to construct progress expenditure property, will be considered made directly by the taxpayer. Construction expenditures made by the taxpayer to a contractor or manufacturer, in general, will not be considered made directly by the taxpayer. Thus, the cost of component parts, such as boilers and turbines, which are purchased and merely installed or assembled by the taxpayer, will not be considered expenditures made directly by the taxpayer for construction. (*See* paragraph (h)(3) of this section to determine when such cost is properly chargeable to capital account.)

(2) *Time when determination made.* The determination of whether property is self-constructed is to be made at the close of the taxable year in which physical work on construction of the property begins, or, if later, the close of the first taxable year to which an election under this section applies. Once it is reasonably estimated that more than half of construction expenditures will be made directly by the taxpayer, the fact the taxpayer actually makes half, or less than half, of the expenditures directly will not affect classification of the property as self-constructed property. Similarly, once a determination

has been made, classification of property as self-constructed property is not affected by a change in circumstances in a later taxable year. However, a significant error unrelated to a change in circumstances may be evidence that the estimate was unreasonable when made.

(3) *Determination based on certain expenditures.* For purposes of determining whether more than half of the expenditures for construction of an item of property will be made directly by the taxpayer, the taxpayer may take into account only expenditures properly includable by the taxpayer in the basis of the property under the provisions of §1.46–3(c). Thus, property is self-constructed property only if more than half of the estimated basis of the property to be used for purposes of determining the credit allowed by section 38 is attributable to expenditures made directly by the taxpayer.

(l) *Definition of non-self-constructed property.* Non-self-constructed property is property that is not self-constructed property. Thus, property is non-self-constructed property if it is reasonable to believe that only half, or less than half, of the expenditures for construction will be made directly by the taxpayer.

(m) *Alternative limitations for public utility, railroad, or airline property.* The alternative limitations on qualified investment under section 46(a) (7) and (8) for public utility, railroad, or airline property (whichever applies) apply in determining the credit for qualified progress expenditures. The determination of whether progress expenditure property will be public utility, railroad, or airline property (whichever applies) when placed in service must be made at the close of the taxable year in which physical work on construction begins or, if later, at the close of the first taxable year for which an election under section 46(d) is in effect. If, at that time, the taxpayer is in a trade or business as a public utility, railroad, or airline (as described in section 46(c)(3)(B) and 46(a)(8) (D) and (E), respectively), it is evidence the property will be public utility, railroad, or airline property when placed in service.

(n) *Leased property.* A lessor of progress expenditure property may not elect under section 48(d) to treat a lessee (or a person who will be a lessee) as having made qualified progress expenditures.

(o) *Election*—(1) *In general.* The election under section 46(d)(6) to increase qualified investment by qualified progress expenditures may be made for any taxable year ending after December 31, 1974. Except as provided in paragraph (o)(2) of this section, the election is effective for the first taxable year for which it is made and for all taxable years thereafter unless it is revoked with the consent of the Commissioner. Except as provided in paragraphs (o) (2) and (3) of this section, the election applies to all qualified progress expenditures made by the taypayer during the taxable year for construction of any progress expenditure property. Thus, the taxpayer may not make the election for one item of progress expenditure property and not for other items. If progress expenditure property is being constructed by or for a partnership, S corporation (as defined in section 1361(a)), trust, or estate, an election under section 46(d)(6) must be made separately by each partner or shareholder, or each beneficiary if the beneficiary, in determining his tax liability, would be allowed investment credit under section 38 for property subject to the election. The election may not be made by a partnership or S corporation, and may be made by a trust or estate only if the trust or estate, in determining its tax liability, would be allowed investment credit under section 38 for property subject to the election. The election of any partner, shareholder, beneficiary, trust, or estate will be effective for that person, even if a related partner, shareholder, beneficiary, trust, or estate does not make the election. An election made by a partner, shareholder, beneficiary, trust, or estate applies to all progress expenditure property of that person. For example, an election made by corporation X, which is a partner in the XYZ partnership, applies to progress expenditure property the corporation holds in its own capacity and also to its interest in progress expenditure property of the partnership.

(2) *Time and manner of making election.* An election under section 46(d)(6) must

be made on Form 3468 and filed with the original income tax return for the first taxable year ending after December 31, 1974 to which the election will apply. An election made before March 2, 1988, by filing a written statement (whether or not attached to the income tax return) will be considered valid. The election may not be made on an amended return filed after the time prescribed for filing the original return (including extensions) for that taxable year. However, an election under this section may be made or revoked by filing a statement with an amended return filed on or before May 31, 1988, if the due date for filing a return for the first taxable year to which the election applies is before May 31, 1988.

(3) *Carryover of election in certain transactions.* In general, and election under section 46(d)(6) does not carry over to the transferee of progress expenditure property (or an interest therein). However, if under section 47(b) the property does not cease to be progress expenditure property because of the transfer, the election will carry over to the transferee. If so, the election will apply only to the property transferred. For rules relating to the determination of qualified progress expenditures of the transferee, see paragraph (r) of this section.

(p) *Partnerships, S corporations, trusts, or estates*—(1) *In general.* Each partner, shareholder, trust, estate, or beneficiary of a trust or estate that makes an election under section 46(d) shall take into account its share of qualified progress expenditures (determined under paragraph (p)(2) of this section) made by the partnership, S corporation, trust, or estate. In determining qualified investment for the year in which the property is placed in service, the basis of the property is apportioned as provided in §§ 1.46–3(f), 1.48–6, or 1.48–5 (whichever applies). Each partner, shareholder, trust, estate, or beneficiary that made the election must reduce qualified investment under section 46(c)(4) for the year the property is placed in service by qualified progress expenditures taken into account by that person.

(2) *Determination of share of qualified progress expenditures.* The share of qualified progress expenditures of each partner, shareholder, trust, estate, or beneficiary that makes an election under section 46(d) must be determined in accordance with the same ratio used under §§ 1.46–3(f)(2), 1.48–5(a)(1), or 1.48–6(a)(1) (whichever applies) to determine its share of basis (or cost). The last sentence of § 1.46–3(f)(2)(i) must be applied by referring to the date on which qualified progress expenditures are paid or chargeable to capital amount (whichever is applicable).

(3) *Examples.* The following examples illustrate this paragraph (p).

Example 1. (i) Corporation X contracts to build a ship for partnership AB that qualifies as progress expenditure property. The contract price is $100,000. Physical work on construction of the ship begins on January 1, 1980. The ship is placed in service on December 31, 1983.

(ii) The AB partnership reports income on the calendar year basis. Partners A and B share profits equally. For A's taxable year ending December 31, 1980, A makes an election under section 46(d) B does not make the election.

(iii) For each of the years 1980, 1981, 1982, and 1983, the AB partnership makes $25,000 payments to corporation X. The payments made in 1980, 1981, and 1982 are qualified progress expenditures. The 1983 payment is not a qualified progress expenditure, because the ship is placed in service in that year.

(iv) For each of the years 1980, 1981, and 1982, A may take into account qualified progress expenditures of $12,500 because A had a 50 percent partnership interest in each of those years.

(v) For 1983, qualified investment for the ship is $100,000. A and B's share are $50,000 each, because each had a 50 percent partnership interest in 1983. However, A must reduce its $50,000 share for 1983 by $37,500, the amount of qualified progress expenditures taken into account by A. B's share is not reduced, because B did not take into account qualified progess expenditures.

Example 2. (i) The facts are the same as in example 1 except that on June 30, 1983, the partnership agreement is amended to admit a new partner, C. The partners agree to share profits equally. There is no special allocation in effect under section 704 with respect to the ship.

(ii) For each of the years 1980, 1981, and 1982, A may take into account qualified progress expenditures of $12,500 because A has a 50 percent partnership interest in those years.

(iii) For 1983, A, B, and C's share of qualified investment is $33,333 each, because each had a 33⅓ percent partnership interest in that year. A must reduce its share to zero, because it took $37,500 into account as qualified progress expenditures. In addition, the excess of the $37,500 over the $33,333 applied as a reduction is subject to recapture under section 47(a)(3)(B). B and C's shares are not reduced, because neither taxpayer took into account qualified progress expenditures.

(q) *Limitation on qualified progress expenditures for taxable years beginning before 1980*—(1) *In general*. (i) Under section 46(d)(7), qualified progress expenditures for any taxable year beginning before January 1, 1980, are limited. The taxpayer must apply the limitation under section 46(d)(7) on an item by item basis. In general, the taxpayer may take into account the applicable percentage (as determined under the table in section 46(d)(7)(A)) of qualified progress expenditures for each of those years. In addition, the taxpayer may take into account for each of those years 20 percent of qualified investment for each of the preceding taxable years determined without applying the limitations of section 46(d)(7).

(ii) The applicable percentage under section 46(d)(7)(A) may be applied only for one taxable year that ends within a calendar year in determining qualified investment for an item of progress expenditure property. For example, calendar year partners of a calendar year partnership may increase qualified investment for 1976 by 20 percent of qualified progress expenditures made in 1975 for an item of property. If the partnership incorporates in 1976 and the taxable year of the corporation begins on July 1, 1976, and ends on June 30, 1977, qualified investment of the corporation for its taxable year beginning on July 1, 1976, cannot be increased by 20 percent of the 1975 expenditure.

(2) *Example*. The following example illustrates this paragraph (q).

Example. (i) Corporation X contracts with A on January 1, 1976, to build an electric generator that qualifies as non-self-constructed progress expenditure property. A will build the generator at a cost of $125,000. Corporation X agrees to pay A $150,000. Corporation X reports income on the calendar year basis. Corporation X makes an election under section 46(d) for 1976. Physical work on construction begins on January 1, 1976. Corporation X makes payments of $30,000 to A for construction of the generator in each of the years 1976, 1977, 1978, 1979, and 1980. A incurs a cost of $25,000 in each of those years for construction of the property. The property is placed in service in 1980.

(ii) For 1976, X may increase qualified investment by $12,000, 40 percent of the payment made in 1976.

(iii) For 1977, corporation X may increase qualified investment by $24,000. Eighteen thousand dollars of that amount is 60 percent of the 1977 payment. The remaining $6,000 is 20 percent of the $30,000 payment made in 1976.

(iv) For 1978, corporation X may increase qualified investment by $36,000. Twenty-four thousand dollars of that amount is 80 percent of the 1978 payment. The remaining $12,000 is 20 percent of the $30,000 payment made in 1976, plus 20 percent of the $30,000 payment made in 1977.

(v) For 1979, corporation X may increase qualified investment by $48,000. Thirty thousand dollars of that amount is 100 percent of the 1979 payment. The remaining $18,000 of that amount is 20 percent of the $30,000 payments made in each of the years 1976, 1977, and 1978.

(vi) Qualified investment for corporation X for 1980 is $30,000. The $30,000 is the basis (or cost) of the generator ($150,000), reduced by qualified progress expenditures allowed with respect to that property ($120,000).

(r) *Special rules for transferred property*—(1) *In general*. A transferee of progress expenditure property (or an interest therein) may take into account qualified progress expenditures for the property only if—

(i) The property is progress expenditure property in the hands of the transferee, and

(ii) The transferee makes an election under section 46(d) or the election made by the transferor (or its predecessor) carries over to the transferee under paragraph (o)(3) of this section.

(2) *Status as progress expenditure property*. (i) If the transfer requires recapture under section 47(a)(3) and § 1.47–1(g) (or would require recapture if the transferor had made an election under section 46(d)), then—

(A) For purposes of determining if the property is progress expenditure property in the hands of the transferee, the normal construction period for the property begins on the date of the transfer, or, if later, on the first day of the first taxable year for which the transferee makes an election under section 46(d), and

(B) For purposes of determining whether the property is self-constructed or non-self-constructed in the hands of the transferee, the amount paid or incurred for the transfer of the property will not be considered a construction expenditure made directly by the transferee.

(ii) If the transfer does not require recapture under section 47(a)(3) and §1.47–1(g), and the election carries over to the taxpayer under paragraph (o)(3) of this section, the property does not lose its status as progress expenditure property because of the transfer.

(3) *Amount of qualified progress expenditures for transferee.* (i) If the transfer does not require recapture under section 47(a)(3) and §147–1(g), and the election carries over to the taxpayer under paragraph (o)(3) of this section, the transferee must determine its qualified progress expenditures—

(A) By using the same normal construction period used by the transferor,

(B) By treating the property as having the same status as self-constructed or non-self-constructed as the property had in the hands of the transferor, and

(C) In the case of non-self-constructed property, by taking into account any excess described in section 46(d)(4)(C)(i) (relating to the excess of payments over the percentage-of-completion limitation) or section 46(d)(4)(C)(ii) (relating to the excess of the percentage-of-completion limitation over the amount of payments) that the transferor would have taken into account with respect to that property.

(ii) If the transfer requires recapture under section 47(a)(3) and §1.47–1(g) (or would require recapture if the transferor had made an election under section 46(d)), the amount paid or incurred for the transfer will be considered a payment for construction of that property to the extent that—

(A) It is properly includible in the basis of the property under §1.46–3(c),

(B) The taxpayer can show the amount is attributable to construction costs paid or chargeable to capital account by the transferor or other person after physical work on construction of the property began, and

(C) It does not exceed the amount by which the transferor has increased qualified investment for qualified progress expenditures incurred with respect to the property (or would have increased qualified investment but for the "lesser of" limitation of section 46(d)(3)(B) or the absence of an election under section 46(d)), plus any amount that would have been treated as a qualified progress expenditure by the transferor had the property not been transferred.

Once the status of the property as self-constructed or non-self-constructed property in the hands of the transferee has been determined, all rules under this section for determining the amount of qualified progress expenditures for that type of property apply. For example, if the property is non-self-constructed in the hands of the transferee, amounts merely incurred (but not paid) for the transfer are not taken into account as qualified progress expenditures. Actual payment is necessary (see paragraph (j)(3) of this section). In applying section 46(d)(3)(B)(ii), the amount paid or incurred for the transfer (to the extent that it qualifies as a payment for construction under the first sentence of this paragraph (r)(3)(ii)) is considered to be part of the overall cost to the transferee of construction by another person, and the portion of construction which is completed during the taxable year is determined by taking into account construction that was completed before the constructed property was acquired by the transferee. If the transferee makes an election under section 46(d) and this section for the taxable year in which the transfer occurs, then for purposes of applying the presumption in section 46(d)(4)(D) that construction is deemed to occur not more rapidly than ratably over the normal construction period, the transferee's normal construction period is considered to have begun on the date on which physical work on construction of the acquired property began.

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

Example 1. Corporation X begins physical work on construction of progress expenditure property for corporation Y on January 1, 1976. Y accurately estimates a 3-year normal construction period and elects under section 46(d) on its return for its taxable year ending December 31, 1976. On January 1, 1978, Y sells the contract rights for construction of the property to corporation Z, which uses a fiscal year ending June 30. Qualified progress expenditures allowed to Y in 1976 and 1977 are subject to recapture under section 47(a)(3). Because Z's normal construction period for the property is less than 2 years (January 1, 1978 to January 1, 1979), the property is not progress expenditure property in Z's hands. Z may not elect progress expenditure treatment for the property.

Example 2. (i) Assume the same facts as in the example in paragraph (j)(7) of this section, except, on December 31, 1982, Y sells its contract rights to the property for $340,000 to corporation Z, which also uses the calendar year. Z pays Y the full $340,000 on that date. The property is still to be placed in service on December 31, 1984, and will not be available for placing in service at an earlier date. Z makes payments to X of $135,000 on December 31, 1983, and $110,000 on December 31, 1984.

(ii) The investment credit allowed Y in 1980 and 1981 for qualified progress expenditures is subject to recapture under section 47(a)(3) and Y may not treat its $85,000 payment in 1982 as a qualified progress expenditure.

(iii) For purposes of determining if the airplane is qualified progress expenditure property with respect to Z, the normal construction period for the property for Z begins on December 31, 1982, the date of transfer. Since the remaining construction period is two years, the property is progress expenditure property if it otherwise qualifies in Z's hands.

(iv) Only $305,000 of the $340,000 payment to Y can qualify as a qualified progress expenditure, because only that amount is attributable to construction costs paid by Y and does not exceed the sum of the amount by which Y increased qualified investment in 1980 and 1981 for qualified progress expenditures ($220,000) and the amount that Y would have treated as a qualified progress expenditure in 1982 ($85,000).

(v) Assume that Z cannot establish that progress in construction has been completed more rapidly than ratably. If Z makes an election under section 46(d) for 1982, then for purposes of applying the percentage of completion limitation, Z's normal construction period is considered to begin on January 1, 1980. Progress is presumed to occur ratably over the 5-year construction period, which is 20 percent in each year.

(vi) For 1982, Z may treat the full $305,000 as a qualified progress expenditure because it is less than the percentage of completion limitation, $330,000 ($110,000 a year for 1980, 1981, and 1982).

(vii) For 1983, Z may treat the entire $135,000 payment as a qualified progress expenditure, since it does not exceed the percentage of completion limitation for that year, $135,000 ($110,000 plus the $25,000 excess from 1982).

(viii) For Z's taxable year ending December 31, 1984, no qualified progress expenditures may be taken into account because the property is placed in service during that year.

[T.D. 8183, 53 FR 6618, Mar. 2, 1988; 53 FR 11162, Apr. 5, 1988]

§ 1.46–6 Limitation in case of certain regulated companies.

(a) *In general*—(1) *Scope of section.* This section does not reflect amendments made to section 46 after enactment of the Revenue Act of 1971, other than the redesignation of section 46(e) as section 46(f) by the Tax Reduction Act of 1975.

(2) *Disallowance of credit.* Under section 46(f), a credit otherwise allowable under section 38 (''credit'') will be disallowed in certain cases with respect to ''section 46(f) property'' as defined in paragraph (b)(1) of this section. Paragraph (f) of this section describes circumstances under which a determination put into effect by a regulatory body will result in the disallowance of the credit. Such a determination will result in a disallowance only if section 46(f) (1) or (2) applies to such property and such determination affects the taxpayer's cost of service or rate base in a manner inconsistent with section 46(f) (1) or (2) (whichever is applicable).

(3) *General rules.* The provisions of section 46(f) (1) and (2) are limitations on the treatment of the credit for ratemaking purposes and for purposes of the taxpayer's regulated books of account only. Under the provisions of section 46(f)(1), the credit may not be flowed through to income (*i.e.*, used to reduce taxpayer's cost of service) but in certain circumstances may be used to reduce rate base (provided that such reduction is restored not less rapidly than ratably). If an election is made under section 46(f)(2), the credit may be flowed through to income (but not more rapidly than ratably) and there may not be any reduction in rate base. If an election is made under section 46(f)(3), none of the limitations of section 46(f) (1) or (2) apply to certain section 46(f) property of the taxpayer. Thus, under the provisions of section 46(f)(3), no credit is disallowed if the credit is treated in any manner for ratemaking purposes, including any manner of treatment permitted under the limitations of section 46(f) (1) or (2).

(4) *Elections*. For rules relating to the manner of making, on or before March 9, 1972, the three elections listed in section 46(f) (1), (2), and (3), see 26 CFR 12.3. For rules relating to the application of such elections, see paragraph (h) of this section.

(5) *Cross references*. For rules with respect to the treatment of corporate reorganizations, asset acquisitions, and taxpayers subject to the jurisdiction of more than one regulatory body, etc., see paragraph (j) of this section.

(6) *Nonapplication of prior law*. Under section 105 (e) of the Revenue Act of 1971, section 203 (e) of the Revenue Act of 1964, 78 Stat. 35, does not apply to section 46(f) property.

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

(1) *Section 46(f) property*. ''Section 46(f) property'' is property described in section 50 that is—

(i) Public utility property within the meaning of section 46(c)(3)(B) (other than nonregulated communication property described in §1.46–3(g)(2)(iv)) or

(ii) Property used predominantly in the trade or business of the furnishing or sale of steam through a local distribution system or of the transportation of gas or steam by pipeline, if the rates for the trade or business are regulated within the meaning of §1.46–3(g)(2)(iii).

For purposes of determining whether property is used predominantly in the trade or business of transportation of gas by pipeline (or of transportation of gas by pipeline and of furnishing or sale of gas through a local distribution system), the rules prescribed in §1.46–3(g)(4) apply except that accounts 365 through 371 inclusive (Transmission Plant) are added to the accounts listed in §1.46–3(g)(4)(i).

(2) *Cost of service*. (i)(A) For purposes of this section, ''cost of service'' is the amount required by a taxpayer to provide regulated goods or services. Cost of service includes operating expenses (including salaries, cost of materials, etc.) maintenance expenses, depreciation expenses, tax expenses, and interest expenses. For purposes of this section, any effect on a taxpayer's permitted return on investment that results from a reduction in the taxpayer's rate base does not constitute a reduction in cost of service, even though, as a technical ratemaking term, ''cost of service'' ordinarily includes a permitted return on investment. In addition, taking into account a deduction for the additional interest that the taxpayer would pay or accrue if the credit were unavailable in determining Federal income tax expense (''synchronization of interest'') does not constitute a reduction in cost of service for purposes of section 46(f)(2). This adjustment to Federal income tax expense may be taken into account in determining cost of service for the regulated accounting period or periods that include the taxable year to which the adjustment relates or for any subsequent regulated accounting period.

(B) See paragraph (b)(3)(ii)(B) of this section for rules relating to the amount of additional interest that the taxpayer would pay or accrue if the credit were unavailable.

(ii) In determining whether, or to what extent, a credit has been used to reduce cost of service, reference shall be made to any accounting treatment that affects cost of service. Examples of such treatment include reducing by all or a portion of the credit the amount of Federal income tax expense taken into account for ratemaking purposes and reducing the depreciable bases of property by all or a portion of the credit for ratemaking purposes.

(3) *Rate base*. (i) For purposes of this section, ''rate base'' is the monetary amount that is multiplied by a rate of return to determine the permitted return on investment.

(ii)(A) In determining whether, or to what extent, a credit has been used to reduce rate base, reference shall be made to any accounting treatment that affects rate base. In addition, in those cases in which the rate of return is based on the taxpayer's cost of capital, reference shall be made to any accounting treatment that reduces the permitted return on investment by treating the credit less favorably than the capital that would have been provided if the credit were unavailable. Thus, the credit may not be assigned a ''cost of capital'' rate that is less than the overall cost of capital rate, determined on the basis of a weighted average, for the capital that would have been provided if the credit were unavailable.

(B) For purposes of determining the cost of capital rate assigned to the credit and the amount of additional interest that the taxpayer would pay or accrue, the composition of the capital that would have been provided if the credit were unavailable may be determined—

(*1*) On the basis of all the relevant facts and circumstances; or

(*2*) By assuming for both such purposes that such capital would be provided solely by common shareholders, preferred shareholders, and long-term creditors in the same proportions and at the same rates of return as the capital actually provided to the taxpayer by such shareholders and creditors.

For purposes of this section, capital provided by long-term creditors does not include deferred taxes as described in section 167(e)(3)(G) or 168(e)(3)(B)(ii).

(C) If a taxpayer's overall rate of return is based on a deemed or hypothetical capital structure, paragraph (b)(3)(ii)(B) of this section shall be applied by treating the deemed or hypothetical capital as if it were the capital actually provided to the taxpayer and determining the composition of the capital that would have been provided if the credit were unavailable in a manner consistent with such treatment.

(iii) Whether, or to what extent, a credit has been used to reduce rate base for any period to which pre-June 23, 1986 rates apply will be determined under 26 CFR 1.46–6(b) (3) and (4) (revised as of April 1, 1985) if such a determination avoids disallowance of a credit that would be disallowed under paragraph (b)(3)(ii) or (4)(ii) of this section. For this purpose, a period of which pre-June 23, 1986 rates apply is any period for which the effect of the credit on rate base for ratemaking purposes is established under a determination put into effect (within the meaning of paragraph (f) of this section) before June 23, 1986.

(4) *Indirect reductions to cost of service or rate base.* (i) Cost of service or rate base is also considered to have been reduced by reason of all or a portion of a credit if such reduction is made in an indirect manner.

(ii) One type of such indirect reduction is any ratemaking decision in which the credit is treated as operating income (subject to ratemaking regulation) or is treated less favorably than the capital that would have been provided if the credit were unavailable. For example, if the credit is accounted for as nonoperating income on a company's regulated books of account but a ratemaking decision has the effect of treating the credit as operating income in determining rate of return to common shareholders, then cost of service has been indirectly reduced by reason of the credit.

(iii) A second type of indirect reduction is any ratemaking decision intended to achieve an effect similar to a direct reduction to cost of service or rate base. In determining whether a ratemaking decision is intended to achieve this effect, consideration is given to all the relevant facts and circumstances of each case, including, but not limited to—

(A) The record of the proceeding,

(B) The regulatory body's orders or opinions (including any dissenting views), and

(C) The anticipated effect of the ratemaking decision on the company's revenues in comparison to a direct reduction to cost of service or rate base by reason of the investment tax credits available to the regulated company.

(iv) This paragraph (b)(4)(iv) describes a situation that is not an indirect reduction to cost of service or rate base by reason of all or a portion of a credit. The ratemaking treatment of credits may affect the financial condition of a company, including the company's ability to attract new capital, the cost of that capital, the company's future financial requirements, the market price of the company's securities, and the degree of risk attributable to investment in those securities. The financial condition may be reflected in certain customary financial indicators such as the comparative capital structure of the company, coverage ratios, price/earnings ratios, and price/book ratios. Under the facts and circumstances test of paragraph (b)(4)(iii) of this section, the consideration of a company's financial condition by a regulatory body is not an indirect reduction to cost of service or rate base, even though such condition, as affected by the ratemaking treatment of the company's investment tax credits, is considered in the development of a reasonable rate of return on common shareholders' investment.

(c) *General rule*—(1) *In general.* Section 46(f)(1) applies to all of the taxpayer's section 46(f) property except property to which an election under section 46(f) (2) or (3) applies. Under section 46(f)(1), the credit for the taxpayer's section 46(f) property will be disallowed if—

(i) The taxpayer's cost of service for ratemaking purposes is reduced by reason of any portion of such credit, or

(ii) The taxpayer's rate base is reduced by reason of any portion of the credit and such reduction in rate base is not restored or is restored less rapidly than ratably within the meaning of paragraph (g) of this section.

(2) *Insufficient natural domestic supply.* The provisions of paragraph (c)(1)(ii) of this section shall not apply to permit any reduction in taxpayer's rate base with respect to its ''short supply property'' if it made an election under the last sentence of section 46(f)(1) on or before March 9, 1972.

(3) *Short supply property.* For purposes of this section, section 46(f) property is ''short supply property'' if—

(i) The property is described in paragraph (b)(1)(ii) of this section,

(ii) The regulatory body described in section 46(c)(3)(B) that has jurisdiction for ratemaking purposes with respect to such trade or business is an agency or instrumentality of the United States, and

(iii) This regulatory body makes a short supply determination and the determination is in effect on the date such property is placed in service.

(4) *Short supply determination.* A short supply determination is made or revoked on the date of its publication in the FEDERAL REGISTER. It is a determination that the natural domestic supply of gas or steam is insufficient to meet the present and future requirements of the domestic economy.

(5) *Dates short supply determination in effect.* (i) A short supply determination is considered to be in effect with respect to section 46(f) property placed in service at any time before the determination is revoked. However, a short supply determination made after June 20, 1979 is not considered to be in effect with respect to section 46(f) property placed in service before such determination was made.

(d) *Special rule for ratable flow-through.* If an election was made under section 46(f)(2) on or before March 9, 1972, section 46(f)(2) applies to all of the taxpayer's section 46(f) property except property to which an election under section 46(f)(3) applies. Under section 46(f)(2), the credit for the taxpayer's section 46(f) property will be disallowed if—

(1) The taxpayer's cost of service, for ratemaking purposes or in its regulated books of account, is reduced by more than a ratable portion of such credit within the meaning of paragraph (g) of this section or

(2) The taxpayer's rate base is reduced by reason of any portion of such credit.

(e) *Flow-through property.* If a taxpayer made an election under section 46(f)(3) on or before March 9, 1972, section 46(f) (1) and (2) do not apply to the taxpayer's section 46(f) property to which section 167(l)(2)(C) applies. In the case of an election under section 46(f)(3), a credit will not be disallowed, notwithstanding a determination by a regulatory body having jurisdiction over such taxpayer that reduces the taxpayer's cost of service or rate base by reason of such credit. In general, section 167(l)(2)(C) applies to property with respect to which a taxpayer may use a flow-through method of accounting (within the meaning of section 167(l)(3)(H)) to take into account the allowance for depreciation under section 167(a). Section 167(l)(2)(C) applies to property even though the taxpayer does not use a flow-through method of accounting with respect to the property. Section 167(l)(2)(C) does not apply to property if the taxpayer can not use a flow-through method of accounting with respect to the property. For example, section 167(l)(2)(C) does not apply to property with respect to which an election under section 167(l)(4)(A) applies. Thus, such property does not qualify for an election under section 46(f)(3).

(f) *Limitations*—(1) *In general.* This paragraph provides rules relating to limitations on the disallowance of credits under section 46(f)(4). Key terms are defined in paragraphs (f) (7), (8), and (9) of this section.

(2) *Disallowance postponed.* There is no disallowance of a credit before the first final inconsistent determination is put into effect for the taxpayer's section 46(f) property.

(3) *Time of disallowance.* A credit is disallowed—

(i) When the first final inconsistent determination is put into effect and

(ii) When any inconsistent determination (whether or not final) is put into effect after the first final inconsistent determination is put into effect.

(4) *Credits disallowed.* A credit is disallowed for section 46(f) property placed in service (within the meaning of §1.46–3(d)) by the taxpayer—

(i) Before the date any inconsistent determination described in paragraph (f)(2) of this section is put into effect and

(ii) On or after such date and before the date a subsequent consistent determination (whether or not final) is put into effect.

(5) *Barred years.* No amount of credit for a taxable year is disallowed under paragraph (f)(3) of this section if, for such year, assessment of a deficiency is barred by any law or rule of law.

(6) *Notification and other requirements.* The taxpayer shall notify the district director of a disallowance of a credit under paragraph (f)(3) of this section within 30 days of the date that the applicable determination is put into effect. In the case of such a disallowance, the taxpayer shall recompute its tax liability for any affected taxable year, and such recomputation shall be made in the form of an amended return where necessary.

(7) *Determinations.* For purposes of this paragraph, the term ''determination'' refers to a determination made with respect to section 46(f) property (other than property to which an election under section 46(f)(3) applies) by a regulatory body described in section 46(c)(3)(B) that determines the effect of the credit—

(i) For purposes of section 46(f)(1), on the taxpayer's cost of service or rate base for ratemaking purposes or

(ii) In the case of a taxpayer that made an election under section 46(f)(2), on the taxpayer's cost of service, for ratemaking purposes or in its regulated books of account, or on the taxpayer's rate base for ratemaking purposes.

A regulatory body does not have to take affirmative action to make a determination. Thus, a regulatory body's failure to take action on a rate schedule filed by a taxpayer is a determination if the rates can be put into effect without further action by the regulatory body.

(8) *Types of determinations.* For purposes of this paragraph—

(i) The term ''inconsistent'' refers to a determination that is inconsistent with section 46(f) (1) or (2) (as the case may be). Thus, for example, a determination to reduce the taxpayer's cost of service by more than a ratable portion of the credit would be a determination that is inconsistent with section 46(f)(2). As a further example, such a determination would also be inconsistent if section 46(f)(1) applied because no reduction in cost of service is permitted under section 46(f)(1).

(ii) The term ''consistent'' refers to a determination that is consistent with section 46(f) (1) or (2) (as the case may be).

(iii) The term ''final determination'' means a determination with respect to which all rights to appeal or to request a review, a rehearing, or a redetermination have been exhausted or have lapsed.

(iv) The term ''first final inconsistent determination'' means the first final determination put into effect after December 10, 1971, that is inconsistent with section 46(f) (1) or (2) (as the case may be).

(9) *Put into effect.* A determination is put into effect on the latter of—

(i) The date it is issued (or, if a first final inconsistent determination, the date it becomes final) or

(ii) The date it becomes operative.

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

Example 1. Corporation X, a calendar-year taxpayer engaged in a public utility activity is subject to the jurisdiction of regulatory body A. On September 15, 1971, X purchases section 46(f) property and places it in service on that date. For 1971, X takes the credit allowable by section 38 with respect to such property. X does not make any election permitted by section 46(f). On October 9, 1972, A makes a determination that X must account for the credit allowable under section 38 in a manner inconsistent with section 46(f)(1). The determination, which was the first determination by A after December 10, 1971, becomes final on January 1, 1973, and holds that X must retroactively adjust the manner in which it accounted for the credit allowable under section 38 starting with the taxable year that began on January 1, 1972. Since, under the provisions of paragraph (f)(8) of this section, the determination by A is put into effect on January 1, 1973 (the date it becomes final), the credit is retroactively disallowed with respect to any of X's section 46(f) property placed in service before January 1, 1973, on any date which occurs during a taxable year with respect to which an assessment of a deficiency has not been barred by any law or rule of law. In addition, the credit is disallowed with respect to X's section 46(f) property placed in service on or after January 1, 1973, and before the date that a subsequent determination by A, which as to X is consistent with section 46(f)(1), is put into effect. Thus, X must amend its income tax return for 1971 to reflect the retroactive disallowance of the credit otherwise allowable under section 38 with respect to the section 46(f) property placed in service on September 15, 1971.

Example 2. The facts are the same as in example 1, except that the first inconsistent determination by A becomes final on April 5, 1972, and requires X to account for the credit for all taxable years beginning on or after January 1, 1973, in a manner inconsistent with section 46(f)(1). Under the provisions of paragraph (f)(8) of this section, the determination was put into effect on January 1, 1973 (the date it became operative). The result is the same as in example 1.

Example 3. The facts are the same as in example 1, except that on June 1, 1975, A issues a determination that X shall retroactively account for the credit allowable by section 38 in a manner consistent with the provisions of section 46(f)(1) for taxable years beginning on or after January 1, 1971. The determination becomes final on January 5, 1976, in the same form as originally issued. The result is the same as in example 1 with respect to property X places in service before June 1, 1975. The credit is allowed with respect to property X places in service on or after June 1, 1975 (the date that the consistent determination is put into effect).

(g) *Ratable methods*—(1) *In general.* Under this paragraph (g), rules are prescribed for purposes of determining whether or not, under section 46(f)(1), a reduction in the taxpayer's rate base with respect to the credit is restored less rapidly than ratably and whether or not under section 46(f)(2) the taxpayer's cost of service for ratemaking purposes is reduced by more than a ratable portion of such credit.

(2) *Regulated depreciation expense.* What is "ratable" is determined by considering the period of time actually used in computing the taxpayer's regulated depreciation expense for the property for which a credit is allowed. "Regulated depreciation expense" is the depreciation expense for the property used by a regulatory body for purposes of establishing the taxpayer's cost of service for ratemaking purposes. Such period of time shall be expressed in units of years (or shorter periods), units of production, or machine hours and shall be determined in accordance with the individual useful life system or composite (or other group asset) account system actually used in computing the taxpayer's regulated depreciation expense. A method of restoring, or reducing, is ratable if the amount to be restored to rate base, or to reduce cost of service (as the case may be), is allocated ratably in proportion to the number of such units. Thus, for example, assume that the regulated depreciation expense is computed under the straight line method by applying a composite annual percentage rate to "original cost" (as defined for purposes of computing regulated depreciation expense). If, with respect to an item of section 46(f) property, the amount to be restored annually to rate base is computed by applying a composite annual percentage rate to the amount by which the rate base was reduced, then the restoration is ratable. Similarly, if cost of service is reduced annually by an amount computed by applying a composite annual percentage rate to the amount of the credit, cost of service is reduced by a ratable portion. If such composite annual

percenage rate were revised for purposes of computing regulated depreciation expense beginning with a particular accounting period, the computation of ratable restoration or ratable portion (as the case may be) must also be revised beginning with such period. A composite annual percentage rate is determined solely by reference to the period of time actually used by the taxpayer in computing its regulated depreciation expense without reduction for salvage or other items such as over and under accruals. A composite annual percentage rate determined by taking into account salvage value or other items shall be considered to be ratable in the case of a determination (whether or not final) issued before March 22, 1979, and any rate order (whether or not final) that is entered into before June 20, 1979, in response to a rate case filed before April 23, 1979. For this purpose, the term ''rate order'' does not include an order by a regulatory body that perfunctorily adopts rates as filed if such rates are suspended or subject to rebate.

(h) *Elections*—(1) *Applicability of elections.* (i) Any election under section 46(f) applies to all of the taxpayer's property eligible for the election, whether or not the taxpayer is regulated by more than one regulatory body.

(ii) Section 46(f)(1) applies to all of the taxpayer's section 46(f) property in the absence of an election under either section 46(f) (2) or (3). If an election is made under section 46(f)(2), section 46(f)(1) does not apply to any of the taxpayer's section 46(f) property.

(iii) An election made under the last sentence of section 46(f)(1) applies to that portion of the taxpayer's section 46(f) property to which section 46(f)(1) applies and which is short supply property within the meaning of paragraph (c)(2) of this section.

(iv) If a taxpayer makes an election under section 46(f)(2) and makes no election under section 46(f)(3), the election under section 46(f)(2) applies to all of the taxpayer's section 46(f) property.

(v) If a taxpayer makes an election under section 46(f)(3), such election applies to all of the taxpayer's section 46(f) property to which section 167(l)(2)(C) applies. Section 46(f) (1) or (2) (as the case may be) applies to that portion of the taxpayer's section 46(f) property that is not property to which section 167(f)(2)(C) applies. Thus, for example, if a taxpayer makes an election under section 46(f)(2) and also makes an election under section 46(f)(3), section 46(f)(3) applies to all of the taxpayer's section 46(f) property to which section 167(l)(2)(C) applies, and section 46(f)(2) applies to the remainder of the taxpayer's section 46(f) property.

(2) *Method of making elections.* See 26 CFR 12.3 for rules relating to the method of making the elections described in section 46(f) (1), (2), or (3).

(i) [Reserved]

(j) *Reorganizations, asset acquisitions, multiple regulation, etc.*—(1) *Taxpayers not entirely subject to jurisdiction of one regulatory body.* (i) If a taxpayer is required by a regulatory body having jurisdiction over less than all of its property to account for the credit under a determination that is inconsistent with section 46(f) (1) or (2) (as the case may be), such credit shall be disallowed only with respect to property subject to the jurisdiction of such regulatory body.

(ii) For purposes of this paragraph (j), a regulatory body is considered to have jurisdiction over property of a taxpayer if the property is included in the rate base for which the regulatory body determines an allowable rate of return for ratemaking purposes or if expenses with respect to the property are included in cost of service as determined by the regulatory body for ratemaking purposes. For example, if regulatory body A, having jurisdiction over 60 percent of an item of corporation X's section 46(f) property, makes a determination which is inconsistent with section 46(f), and if regulatory body B, having jurisdiction over the remaining 40 percent of such item of property, makes a consistent determination (or if the remaining 40 percent is not subject to the jurisdiction of any regulatory body), then 60 percent of the credit for such item will be disallowed. For a further example, if regulatory body A, having jurisdiction over 60 percent of X's section 46(f) property, has jurisdiction over 100 percent of a particular generator, 100 percent of the credit for such generator will be disallowed.

(iii) For rules which provide that the 3 elections under section 46(f) may not be made with respect to less than all of the taxpayer's property eligible for the election, see paragraph (h)(1)(i) of this section.

(2) [Reserved]

(k) *Treatment of accumulated deferred investment tax credits upon the deregulation of public utility property*—(1) *Scope*—(i) *In general.* This paragraph (k) provides rules for the application of former sections 46(f)(1) and 46(f)(2) of the Internal Revenue Code to a taxpayer with respect to public utility property that ceases, whether by disposition, deregulation, or otherwise, to be public utility property with respect to the taxpayer and that is not described in paragraph (k)(1)(ii) of this section (deregulated public utility property).

(ii) *Exception.* This paragraph (k) does not apply to property that ceases to be public utility property with respect to the taxpayer on account of an ordinary retirement within the meaning of §1.167(a)–11(d)(3)(ii).

(2) *Ratable amount*—(i) *Restoration of rate base reduction.* A reduction in the taxpayer's rate base on account of the credit with respect to public utility property that becomes deregulated public utility property is restored ratably during the period after the property becomes deregulated public utility property if the amount of the reduction remaining to be restored does not, at any time during the period, exceed the restoration percentage of the recoverable stranded cost of the property at such time. For this purpose—

(A) The stranded cost of the property is the cost of the property reduced by the amount of such cost that the taxpayer has recovered through regulated depreciation expense during the period before the property becomes deregulated public utility property;

(B) The recoverable stranded cost of the property at any time is the stranded cost of the property that the taxpayer will be permitted to recover through rates after such time; and

(C) The restoration percentage for the property is determined by dividing the reduction in rate base remaining to be restored with respect to the property immediately before the property becomes deregulated public utility property by the stranded cost of the property.

(ii) *Cost of service reduction.* Reductions in the taxpayer's cost of service on account of the credit with respect to public utility property that becomes deregulated public utility property are ratable during the period after the property becomes deregulated public utility property if the cumulative amount of the reduction during such period does not, at any time during the period, exceed the flowthrough percentage of the cumulative stranded cost recovery for the property at such time. For this purpose—

(A) The stranded cost of the property is the cost of the property reduced by the amount of such cost that the taxpayer has recovered through regulated depreciation expense during the period before the property becomes deregulated public utility property;

(B) The cumulative stranded cost recovery for the property at any time is the stranded cost of the property that the taxpayer has been permitted to recover through rates on or before such time; and

(C) The flowthrough percentage for the property is determined by dividing the amount of credit with respect to the property remaining to be used to reduce cost of service immediately before the property becomes deregulated public utility property by the stranded cost of the property.

(3) *Cross reference.* See §1.168(i)–(3) for rules relating to the treatment of balances of excess deferred income taxes when public utility property becomes deregulated public utility property.

(4) *Effective/applicability dates*—(i) *In general.* Except as provided in paragraph (k)(4)(ii) of this section, this paragraph (k) applies to public utility property that becomes deregulated public utility property with respect to a taxpayer after December 21, 2005.

(ii) *Property that becomes public utility property of the transferee.* This paragraph (k) does not apply to property that becomes deregulated public utility property with respect to a taxpayer an account of a transfer on or before March 20, 2008 if after the transfer the property is public utility property of the transferee.

(iii) *Application of regulation project (REG–104385–01).* A reduction in the taxpayer's cost of service will be treated as ratable if it is consistent with the proposed rules in regulation project (REG–104385–01) (68 FR 10190) March 4, 2003, and occurs during the period beginning on March 5, 2003, and ending on the earlier of—

(A) The last date on which the utility's rates are determined under the rate order in effect on December 21, 2005; or

(B) December 21, 2007.

[T.D. 7602, 44 FR 17668, Mar. 23, 1979, as amended by T.D. 8089, 51 FR 18777, May 22, 1986; T.D. 9387, 73 FR 14936, Mar. 20, 2008; 73 FR 18708, Apr. 7, 2008]

§ 1.46–7 Statutory provisions; plan requirements for taxpayers electing additional investment credit, etc.

As amended by sections 802(b)(7), and 803 (c), (d), and (e) of the Tax Reform Act of 1976 (90 Stat. 1520), section 301 (d), (e), and (f) of the Tax Reduction Act of 1975 (89 Stat. 38) provides as follows:

Sec. 301. Increase in investment credit * * *

(d) *Plan requirements for taxpayers electing additional credit.* In order to meet the requirements of this subsection—

(1) Except as expressly provided in subsections (e) and (f), a corporation (hereinafter in this subsection referred to as the "employer") must establish an employee stock ownership plan (described in paragraph (2)) which is funded by transfers of employer securities in accordance with the provisions of paragraph (6) and which meets all other requirements of this subsection.

(2) The plan referred to in paragraph (1) must be a defined contribution plan established in writing which—

(A) Is a stock bonus plan, a stock bonus and a money purchase pension plan, or a profit-sharing plan,

(B) Is designed to invest primarily in employer securities, and

(C) Meets such other requirements (similar to requirements applicable to employee stock ownership plans as defined in section 4975(e)(7) of the Internal Revenue Code of 1954) as the Secretary of the Treasury or his delegate may prescribe.

(3) The plan must provide for the allocation of all employer securities transferred to it or purchased by it (because of the requirements of section 46(a)(2)(B) of the Internal Revenue Code of 1954) to the account of each participant (who was a participant at any time during the plan year, whether or not he is a participant at the close of the plan year) as of the close of each year in an amount which bears substantially the same proportion to the amount of all such securities allocated to all participants in the plan for that plan year as the amount of compensation paid to such participant (disregarding any compensation in excess of the first $100,000 per year) bears to the compensation paid to all such participants during that year (disregarding any compensation in excess of the first $100,000 with respect to any participant). Notwithstanding the first sentence of this paragraph, the allocation to participants' accounts may be extended over whatever period may be necessary to comply with the requirements of section 415 of the Internal Revenue Code of 1954. For purposes of this paragraph, the amount of compensation paid to a participant for a year is the amount of such participant's compensation within the meaning of section 415(c)(3) of such Code for such year.

(4) The plan must provide that each participant has a nonforfeitable right to any stock allocated to his account under paragraph (3), and that no stock allocated to a participant's account may be distributed from that account before the end of the eighty-fourth month beginning after the month in which the stock is allocated to the account except in the case of separation from the service, death, or disability.

(5) The plan must provide that each participant is entitled to direct the plan as to the manner in which any employer securities allocated to the account of the participant are to be voted.

(6) On making a claim for credit, adjustment, or refund under section 38 of the Internal Revenue Code of 1954, the employer states in such claim that it agrees, as a condition of receiving any such credit, adjustment, or refund—

(A) In the case of a taxable year beginning before January 1, 1977, to transfer employer securities forthwith to the plan having an aggregate value at the time of the claim of 1 percent of the amount of the qualified investment (as determined under section 46 (c) and (d) of such Code) of the taxpayer for the taxable year, and

(B) In the case of a taxable year beginning after December 31, 1976—

(i) To transfer employer securities to the plan having an aggregate value at the time of the claim of 1 percent of the amount of the qualified investment (as determined under section 46 (c) and (d) of such Code) of the employer for the taxable year,

(ii) Except as provided in clause (iii), to effect the transfer not later than 30 days after the time (including extensions) for filing its income tax return for a taxable year, and

(iii) In the case of an employer whose credit (as determined under section 46(a)(2)(B) of such Code) for a taxable year beginning after

December 31, 1976, exceeds the limitations of paragraph (3) of section 46(a) of such Code—

(I) To effect that portion of the transfer allocable to investment credit carrybacks of such excess credit at the time required under clause (ii) for the unused credit year (within the meaning of section 46(b) of such Code), and

(II) To effect that portion of the transfer allocable to investment credit carryovers of such excess credit at the time required under clause (ii) for the taxable year to which such portion is carried over.

For purposes of meeting the requirements of this paragraph, a transfer of cash shall be treated as a transfer of employer securities if the cash is, under the plan, used to purchase employer securities.

(7) Notwithstanding any other provision of law to the contrary, if the plan does not meet the requirements of section 401 of the Internal Revenue Code of 1954—

(A) Stock transferred under paragraph (6) or subsection (e)(3) and allocated to the account of any participant under paragraph (3) and dividends thereon shall not be considered income of the participant or his beneficiary under the Internal Revenue Code of 1954 until actually distributed or made available to the participant or his beneficiary and, at such time, shall be taxable under section 72 of such Code (treating the participant or his beneficiary as having a basis of zero in the contract),

(B) No amount shall be allocated to any participant in excess of the amount which might be allocated if the plan met the requirements of section 401 of such Code, and

(C) The plan must meet the requirements of sections 410 and 415 of such Code.

(8)(A) Except as provided in subparagraph (B)(iii), if the amount of the credit determined under section 46(a)(2)(B) of the Internal Revenue Code of 1954 is recaptured or redetermined in accordance with the provisions of such Code, the amounts transferred to the plan under this subsection and subsection (e) and allocated under the plan shall remain in the plan or in participant accounts, as the case may be, and continue to be allocated in accordance with the plan.

(B) If the amount of the credit determined under section 46(a)(2)(B) of the Internal Revenue Code of 1954 is recaptured in accordance with the provisions of such Code—

(i) The employer may reduce the amount required to be transferred to the plan under paragraph (6) of this subsection, or under paragraph (3) of subsection (e), for the current taxable year or any succeeding taxable years by the portion of the amount so recaptured which is attributable to the contribution to such plan,

(ii) Notwithstanding the provisions of paragraph (12), the employer may deduct such portion, subject to the limitations of section 404 of such Code (relating to deductions for contributions to an employees' trust or plan), or

(iii) If the requirements of subsection (f)(1) are met, the employer may withdraw from the plan an amount not in excess of such portion.

(C) If the amount of the credit claimed by an employer for a prior taxable year under section 38 of the Internal Revenue Code of 1954 is reduced because of a redetermination which becomes final during the taxable year, and the employer transferred amounts to a plan which were taken into account for purposes of this subsection for that prior taxable year, then—

(i) The employer may reduce the amount it is required to transfer to the plan under paragraph (6) of this subsection, or under paragraph (3) of subsection, (e), for the taxable year or any succeeding taxable year by the portion of the amount of such reduction in the credit or increase in tax which is attributable to the contribution to such plan, or

(ii) Notwithstanding the provisions of paragraph (12), the employer may deduct such portion subject to the limitations of section 404 of such Code.

(9) For purposes of this subsection, the term—

(A) ''Employer securities'' means common stock issued by the employer or a corporation which is a member of a controlled group of corporations which includes the employer (within the meaning of section 1563 (a) of the Internal Revenue Code of 1954, determined without regard to section 1563 (a)(4) and (e)(3)(C) of such Code) with voting power and dividend rights no less favorable than the voting power and dividend rights of other common stock issued by the employer or such controlling corporation, or securities issued by the employer or such controlling corporation, convertible into such stock, and

(B) ''Value'' means the average of closing prices of the employer's securities, as reported by a national exchange on which securities are listed, for the 20 consecutive trading days immediately preceding the date of transfer or allocation of such securities or, in the case of securities not listed on a national exchange, the fair market value as determined in good faith and in accordance with regulations issued by the Secretary of the Treasury or his delegate.

(10) The Secretary of the Treasury or his delegate shall prescribe such regulations and require such reports as may be necessary to carry out the provisions of this subsection and subsections (e) and (f).

(11) If the employer fails to meet any requirement imposed under this subsection or subsection (e) or (f) or under any obligation undertaken to comply with the requirement of this subsection or subsection (e) or (f), he

is liable to the United States for a civil penalty of an amount equal to the amount involved in such failure. The preceding sentence shall not apply if the taxpayer corrects such failure (as determined by the Secretary of the Treasury or his delegate) within 90 days after notice thereof. For purposes of this paragraph, the term ''amount involved'' means an amount determined by the Secretary or his delegate, but not in excess of 1 percent of the qualified investment of the taxpayer for the taxable year under section 46(a)(2)(B) and not less than the product of one-half of one percent of such amount multiplied by the number of months (or parts thereof) during which such failure continues. The amount of such penalty may be collected by the Secretary of the Treasury in the same manner in which a deficiency in the payment of Federal income tax may be collected.

(12) Notwithstanding any provision of the Internal Revenue Code of 1954 to the contrary, no deductions shall be allowed under section 162, 212, or 404 of such Code for amounts transferred to an employee stock ownership plan and taken into account under this subsection.

(13)(A) As reimbursement for the expense of establishing the plan, the employer may withhold from amounts due the plan for the taxable year for which the plan is established, or the plan may pay, so much of the amounts paid or incurred in connection with the establishment of the plan as does not exceed the sum of 10 percent of the first $100,000 that the employer is required to transfer to the plan for that taxable year under paragraph (6) (including any amounts transferred under subsection (e)(3)) and 5 percent of any amount in excess of the first $100,000 of such amount.

(B) As reimbursement for the expense of administering the plan, the employer may withhold from amounts due the plan, or the plan may pay, so much of the amounts paid or incurred during the taxable year as expenses of administering the plan as does not exceed the smaller of—

(i) The sum of 10 percent of the first $100,000 and 5 percent of any amount in excess of $100,000 of the income from dividends paid to the plan with respect to stock of the employer during the plan year ending with or within the employer's taxable year, or

(ii) $100,000.

(14) The return of a contribution made by an employer to an employee stock ownership plan designed to satisfy the requirements of this subsection or subsection (e) (or a provision for such a return) does not fail to satisfy the requirements of this subsection, subsection (e), section 401(a) of the Internal Revenue Code of 1954, or section 403(c)(1) of the Employee Retirement Income Security Act of 1974 if—

(A) The contribution is conditioned under the plan upon determination by the Secretary of the Treasury that such plan meets the applicable requirements of this subsection, subsection (e), or section 401(a) of such Code.

(B) The application for such a determination is filed with the Secretary not later than 90 days after the date on which the credit under section 38 is allowed, and

(C) The contribution is returned within one year after the date on which the Secretary issues notice to the employer that such plan does not satisfy the requirements of this subsection, subsection (e), or section 401(a) of such Code.

(e) *Plan requirements for taxpayers electing additional one-half percent credit*—(1) *General rule.* For purposes of clause (ii) of section 46(a)(2)(B) of the Internal Revenue Code of 1954, the amount determined under this subsection for a taxable year is an amount equal to the sum of the matching employee contributions for the taxable year which meet the requirements of this subsection.

(2) *Election; basic plan requirements.* No amount shall be determined under this subsection for the taxable year unless the corporation elects to have this subsection apply for that year. A corporation may not elect to have the provisions of this subsection apply for a taxable year unless the corporation meets the requirements of subsection (d) and the requirements of this subsection.

(3) *Employer contribution.* On making a claim for credit, adjustment, or refund under section 38 of the Internal Revenue Code of 1954, the employer shall state in such claim that the employer agrees, as a condition of receiving any such credit, adjustment, or refund attributable to the provisions of section 46(a)(2)(B)(ii) of such Code, to transfer at the time described in subsection (d)(6)(B) employer securities (as defined in subsection (d)(9)(A)) to the plan having an aggregate value at the time of the transfer of not more than one-half of one percent of the amount of the qualified investment (as determined under subsections (c) and (d) of section 46 of such Code) of the taxpayer for the taxable year. For purposes of meeting the requirements of this paragraph, a transfer of cash shall be treated as a transfer of employer securities if the cash is, under the plan, used to purchase employer securities.

(4) *Requirements relating to matching employee contributions.* (A) An amount contributed by an employee under a plan described in subsection (d) for the taxable year may not be treated as a matching employee contribution for that taxable year under this subsection unless—

(i) Each employee who participates in the plan described in subsection (d) is entitled to make such a contribution,

(ii) The contribution is designated by the employee as a contribution intended to be used for matching employer amounts transferred under paragraph (3) to a plan which meets the requirements of this subsection, and

(iii) The contribution is in the form of an amount paid in cash to the employer or plan administrator not later than 24 months after the close of the taxable year in which the portion of the credit allowed by section 38 of such Code (and determined under clause (ii) of section 46 (a)(2)(B) of such Code which the contribution is to match) is allowed, and is invested forthwith in employer securities (as defined in subsection (d)(9)(A)).

(B) The sum of the amounts of matching employee contributions taken into account for purposes of this subsection for any taxable year may not exceed the value (at the time of transfer) of the employer securities transferred to the plan in accordance with the requirements of paragraph (3) for the year for which the employee contributions are designated as matching contributions.

(C) The employer may not make participation in the plan a condition of employment and the plan may not require matching employee contributions as a condition of participation in the plan.

(D) Employee contributions under the plan must meet the requirements of section 401(a)(4) of such Code (relating to contributions).

(5) A plan must provide for allocation of all employer securities transferred to it or purchased by it under this subsection to the account of each participant (who was a participant at any time during the plan year, whether or not he is a participant at the close of the plan year) as of the close of the plan year in an amount equal to his matching employee contributions for the year. Matching employee contributions and amounts so allocated shall be deemed to be allocated under subsection (d)(3).

(f) *Recapture*—(1) *General rule.* Amounts transferred to a plan under subsection (d)(6) or (e)(3) may be withdrawn from the plan by the employer if the plan provides that while subject to recapture—

(A) Amounts so transferred with respect to a taxable year are segregated from other plan assets, and

(B) Separate accounts are maintained for participants on whose behalf amounts so transferred have been allocated for a taxable year.

(2) *Coordination with other law.* Notwithstanding any other law or rule of law, an amount withdrawn by the employer will neither fail to be considered to be nonforfeitable nor fail to be for the exclusive benefit of participants or their beneficiaries merely because of the withdrawal from the plan of—

(A) Amounts described in paragraph (1), or

(B) Employer amounts transferred under subsection (e)(3) to the plan which are not matched by matching employee contributions or which are in excess of the limitations of section 415 of such Code,

nor will the withdrawal of any such amount be considered to violate the provisions of section 403(c)(1) of the Employee Retirement Income Security Act of 1974.

[Sec. 301(d) of the Tax Reduction Act of 1975 (89 Stat. 38) as amended by sec. 802(b)(7) and sec. 803 (c) and (e) of the Tax Reform Act of 1976 (90 Stat. 1520); sec. 301 (e) and (f) of the Tax Reduction Act of 1975 as added by sec. 803(d) of the Tax Reform Act of 1976]

(Sec. 301(d)(2)(C) of the Tax Reduction Act of 1975; sec. 7805 of the Internal Revenue Code of 1954 (89 Stat. 38, 68A Stat. 917; 26 U.S.C. 7805)

[T.D. 7857, 47 FR 54793, Dec. 6, 1982]

§ 1.46–8 Requirements for taxpayers electing additional one-percent investment credit (TRASOP's).

(a) *Introduction*—(1) *In general.* A corporation may elect under section 46(a)(2)(B) of the Code to obtain an additional investment credit for property described in section 46(a)(2)(D). This section provides rules for electing to have the provisions of section 46(a)(2)(B) apply and for implementing an employee stock ownership plan under section 301(d) of the Tax Reduction Act of 1975 (''1975 TRA''). The plan must meet the formal requirements of paragraph (d), and the operational requirements of paragraph (e), of this section. An additional credit may be obtained for the periods described in section 46(a)(2)(D). Unless otherwise indicated, statutory references in this section are to the Internal Revenue Code of 1954 as in effect prior to the amendments made by the Revenue Act of 1978.

(2) *Reports.* The returns required by section 6058(a) must be filed on behalf of a plan established under paragraph (c)(7) of this section, whether or not the plan is qualified under section 401(a).

(3) *Cross-references.* The following table indicates where in this section provisions appear relating to each provision of section 301 (d) and (f) of the 1975 TRA.

Section 301	Section 1.46–8	Subject
(d)(1)	(c)(7)(i), (c)(8)(i).	Establishing a TRASOP, in general; funding a TRASOP, in general.
(2)(A)	(c)(7)(ii)	Type of plan.

Section 301	Section 1.46–8	Subject
(B)	(d)(3), (e)(10)	Investment design.
(C)	(d)(1)	Plan requirements, in general.
(3)	(d)(6)	Allocation.
	(b)(8)	Compensation, definition.
(4)	(d)(7)	Nonforfeitability.
	(d)(9)	Distributions.
(5)	(d)(8)	Voting rights.
(6)	(c)	Procedures for additional credit.
(7)(A)	(c)(7)(ii)	Taxability, non-401(a) TRASOP.
(B)	(e)(3)	Allocations under 401(a).
(C)	(e)(3)	Section 410 and section 415 requirements.
(8)	(e)(9)	Reductions of investment credit.
(9)(A)	(b)(4)	Employer securities, definition.
	(e)(10), (f)	Employer securities, requirements.
(B)	(b)(7)	Value, definition.
(10)	(a)(2)	Reporting requirements.
(11)	(h)	Failure to comply.
(12)	(c)(10)	Deductibility.
(13)	(e) (6) and (7)	Reimbursement for expenses.
(14)	(c)(8)(v) and (d)(7)(i).	Contingent contributions.
(f)	(d)(7), (e)(8)(vii), (f).	Withdrawals of TRASOP securities.

(b) *Definitions*. When used in this section, the terms listed below have the indicated meanings:

(1) *TRASOP*. A ''TRASOP'' is an employee stock ownership plan that meets the requirements of section 301(d) of the 1975 TRA. See §1.46–7. It is a type of plan described in paragraph (d)(1) of this section and may, but need not, be an ESOP under §54.4975–11 of this chapter (Pension Excise Tax Regulations). See §1.46–8(d)(5) concerning use of TRASOP assets as collateral for debts and expenses of the plan.

(2) *Additional credit*. An ''additional credit'' is the additional one-percent investment credit under section 46(a)(2)(B)(i).

(3) *Employer*. An ''employer'' is a corporation that establishes a TRASOP.

(4) *Employer securities*—(i) *In general*. ''Employer securities'' are common stock, and securities convertible into common stock, of the employer or of a corporation that is a member of a controlled group of corporations including the employer. Employer securities must meet the requirements of paragraph (g) of this section. Membership in a controlled group for purposes of this section is determined under section 414(b) of the Code.

(ii) *Pre-1977 employer securities*. In addition, employer securities acquired by a TRASOP before January 1, 1977, include common stock, and securities convertible into common stock, of a corporation in control of the employer within the meaning of section 368(c).

(iii) *Caution*. An employer security under this section is not necessarily a qualifying employer security as defined in section 407(d)(5) of the Employee Retirement Income Security Act of 1974 (ERISA) or section 4975(e)(8). Moreover, sections 406, 407, and 408 of ERISA in certain cases limit the acquisition and disposition of qualifying employer securities as defined in section 407(d)(5) of ERISA.

(5) *TRASOP securities*. ''TRASOP securities'' are employer securities that—

(i) Are transferred to a TRASOP, or acquired with cash transferred to a TRASOP, to obtain an additional credit, and

(ii) Except as provided under paragraphs (g) (4) and (5) of this section, or as required by applicable law, are subject to no other put, call, or other option, or buy-sell or similar arrangement while held by the plan.

(6) *Publicly traded*. The term ''publicly traded'' has the meaning specified in §54.4975–7(b)(1)(iv) of this chapter.

(7) *Value*—(i) *In general*. With respect to the transfer of TRASOP securities by a corporation to a TRASOP or the acquisition of TRASOP securities with cash transferred by a corporation to a TRASOP, ''value'' means fair market value determined in good faith and based on all relevant factors as of the date of transfer or acquisition of the TRASOP securities. If the plan acquires TRASOP securities from other than a disqualified person within the meaning of section 4975(e)(2), a good faith determination of value includes a determination of fair market value based on an appraisal independently arrived at by a person who customarily makes such appraisals and who is independent of any person from whom the TRASOP securities are acquired.

(ii) *Twenty-day average rule*. A special 20-day average valuation rule applies to certain publicly traded securities transferred by a corporation to a TRASOP. It does not apply to securities acquired with cash transferreed by a corporation to a TRASOP. Under the special rule, the term ''value'' refers to an average of daily closing prices for a security, as reported on any national securities exchange or as quoted on any system sponsored by a national securities association, over the 20 consecutive trading days immediately preceding the applicable last day described in paragraph (c)(8)(i) of this section. The average is based on the closing prices for each day when the security is in fact traded during the 20-day period. However, the special rule does not apply unless the security is in fact traded for at least 10 of the 20 days.

(iii) *20-day average transitional exception.* If a TRASOP security is transferred before March 20, 1979, the plan may value the security on the basis of the 20 consecutive trading days preceding the date on which the security is transferred or the date as of which the security is allocated to a participant's account.

(8) *Compensation.* ''Compensation'' means ''participant's compensation'' under section 415(c)(3) and §1.415–2(d). However, except for purposes of applying section 415, compensation must be determined for a plan year, not a limitation year.

(c) *Procedures for additional credit*—(1) *Applicable year*—(i) *General rule.* With respect to a qualified investment, the ''applicable year'' of a corporation is generally the taxable year in which the investment is made. For purposes of this section, an investment is made either in a year when section 38 property is placed in service or in a year when qualified progress expenditures are incurred.

(ii) *Carryover option.* A corporation may determine the applicable years for qualified investments made in any taxable year beginning after December 31, 1976, under the following method: The first applicable year with respect to the additional credit for a given year's qualified investment is the year the qualified investment is made or, if later, the first taxable year for which any additional credit is allowable if claimed for that qualified investment. If there is an investment credit carryover from the first applicable year, each taxable year to which any part of the additional credit for that qualified investment is carried over is also an applicable year. If the carryover treatment is elected for the additional credit attributable to a year's qualified investment, all applicable years for the additional credit attributable to that investment must be determined under the carryover option.

(iii) *Increased credit.* A taxable year in which a corporation's additional credit is increased because of a redetermination is also an applicable year. See paragraph (c)(9)(iv) of this section.

(iv) *Illustration.* To illustrate the application of paragraphs (c)(1) (i) and (ii) of this section, assume that a calendar-year corporation makes a qualified investment in 1977 and that 1977 is an unused credit year described in section 46(b)(1). If the general rule is applied, 1977 is an applicable year. However, because 1977 is an unused credit year (at least with respect to the additional credit), if the corporation does not elect to treat 1977 as an applicable year but carries over its entire additional credit for 1977 to 1978 and uses it in 1978, then 1978 is an applicable year. If part of the additional credit is carried over further to 1979, the year 1979 is also an applicable year.

(v) *Change in method.* The choice between the general rule and carryover option methods of determining the additional credit attributable to applicable years is made with respect to each year's qualified investment, and does not bind the corporation with respect to selection of methods for the additional credit attributable to other years' qualified investment. A failure to comply does not occur merely because a corporation elects to apply either method for the additional credit attributable to separate years' qualified investment.

(2) *Time and manner of electing.* A corporation with a qualified investment must elect to be eligible for an additional credit by attaching a statement of election—

(i) To its income tax return, filed on or before the due date including extensions of time, for a taxable year not later than its first applicable year with respect to a qualified investment, or

(ii) In the case of a return filed before December 31, 1975, to an amended return filed on or before December 31, 1975.

(3) *Statement of election.* The statement of election must contain the name and taxpayer identification number of the corporation. Also, it must declare in the following words, or in words having substantially the same meaning, that:

(i) The corporation elects to have section 46(a)(2)(B)(i) of the Internal Revenue Code of 1954 apply; and

(ii) The corporation agrees to implement (or continue to implement, as appropriate) a TRASOP and to claim the additional credit as required by §1.46–8 of the Income Tax Regulations.

(4) *Separate election.* A separate election must be made for each taxable year's qualified investment to obtain an additional credit for that qualified investment. If a corporation does not make a timely election to obtain an additional credit for a taxable year, it may not subsequently make the election on an amended return or otherwise.

(5) *No partial election.* An election to obtain an additional credit applies to a corporation's entire qualified investment for a taxable year. Thus, a corporation may not elect to obtain a partial additional credit for any year's qualified investment. However, the partial disallowance of an additional credit will not result in an election being treated as a partial election. Also, an election by a member of a controlled group of corporations that applies only to the electing member's qualified investment is not a partial election. See §1.46–8(h)(9) with respect to transitional rules for elections made before January 19, 1979.

(6) *No revocation of election.* After the time for electing the additional credit has expired for a taxable year, a corporation may not revoke its election for that year.

(7) *Establishing a TRASOP*—(i) *In general.* A corporation electing to obtain an additional credit must establish a TRASOP with accompanying trust on or before the last day for making the election regardless of when in fact the election is made. A TRASOP is considered to be in existence on a particular date if it meets the requirements of §1.410(a)–2(c)(1). A new plan need not be established if an existing plan qualifies as a TRASOP, or is amended to meet the requirements of this section, on or before the last day for making the election. The requirements of this section are not satisfied merely by establishing and crediting a separate "TRASOP" account on the corporation's books.

(ii) *Type of plan.* A TRASOP need not meet the requirements of section 401(a). However, it must be a stock bonus plan, a combination stock bonus plan and money purchase pension plan, or a profit-sharing plan under §1.401–1(b)(1) of this chapter. See section 301(d)(7)(A) of the 1975 TRA for the tax consequences relating to a TRASOP that does not meet the requirements of section 401(a). See also title I of ERISA for additional provisions applicable to a TRASOP as an employee pension benefit plan under section 3(2) of ERISA.

(8) *Funding a TRASOP*—(i) *In general.* A corporation electing to obtain an additional credit must fund its TRASOP by transferring TRASOP securities or cash to it no later than 30 days after the applicable last day. That day is the last day for electing the additional credit, irrespective of when the election is actually made. However, in the case of an investment credit that was carried over and claimed in a subsequent applicable year by reason of paragraph (c)(1)(ii) of this section, that day is the last day (including extensions) for filing its income tax return for the subsequent applicable year. TRASOP securities may be transferred to a plan at any time during the applicable year, but not before the first day of an applicable year. If TRASOP securities are transferred to the plan within the permissible time period after the close of the applicable year, they are treated as transferred during that applicable year first until all TRASOP securities required by this paragraph (c) for that applicable year are transferred to, and taken into account under, the TRASOP. Thus, for example, assume that on a return filed on September 17, 1979 (with extensions, the last day for filing a return for 1978), a calendar-year corporation claims an additional credit

of $5,000 for 1978, an applicable year under the TRASOP. No contributions were made in 1978 on account of the 1978 credit, but TRASOP securities with a value of $6,000 were contributed in 1979. The corporation also expects to be able to claim an additional credit of $10,000 for 1979. TRASOP securities transferred between January 1, 1979, and October 17, 1979, must be taken into account under the plan for 1978 before they are taken into account for 1979. Accordingly, securities having a value of $5,000 are applied against the obligation for 1978, and $1,000 of the contribution is retained to be applied to the eventual obligation for 1979.

(ii) *Cash transfers*. A corporation may transfer cash to the TRASOP instead of TRASOP securities only if the TRASOP uses the cash to acquire TRASOP securities no later than 30 days after the time for funding the TRASOP.

(iii) *Valuation*. The value of the TRASOP securities for an applicable year must equal one percent of the corporation's qualified investment for that year. However, if paragraph (c)(1)(ii) of this section is followed by a corporation, the value of TRASOP securities for an applicable year must equal the amount of additional credit claimed for that year.

(iv) *Cash reserve*. The value of TRASOP securities acquired with cash transferred by a corporation may be reduced by two items. The first item is an amount not more than the value of fractional shares allocable to participants entitled to receive an immediate distribution at the time of the transfer. The second item is start-up expenses and administrative expenses to the extent permitted under section 301(d)(13) of the 1975 TRA and paragraphs (e) (6) and (7) of this section.

(v) *Conditional funding*. The funding of a TRASOP may be conditional if the TRASOP satisfies the provisions of section 301(d)(14) of the 1975 TRA. For purposes of section 301(d)(14), an investment credit is considered to be allowed on the date the election for the applicable year is made under paragraph (c)(2) of this section.

(vi) *Certain benefit offset mechanisms*. A TRASOP will be deemed to be not funded to the extent that TRASOP securities are used to offset benefits under a defined benefit plan.

(9) *Claiming additional credit*—(i) *In general*. Section 46(a)(3) subjects the amount of investment credit earned with respect to a taxpayer's qualified investment for a taxable year to a limitation based on the corporation's tax liability.

(ii) *Unused credit year*. Section 46(a)(1) provides a first-in-first-out rule for the investment credit in a taxable year. Section 46(b)(1) provides for the carryback and carryover of unused credits. If less than all of a taxpayer's credit earned for a taxable year is allowable, the 10-percent credit determined under section 46(a)(2)(A) earned for a particular year is allowed first. Any portion of the additional credit for a taxable year that is not allowable may be carried back or carried over to the extent permitted by section 46(b)(1). However, an additional credit which is allowed for a taxable year is not reduced by a carryback to that year of an unused credit from a succeeding taxable year.

(iii) *Example*. Paragraph (c)(9)(ii) of this section is illustrated by the following example:

Example. A calendar-year corporation begins operation and establishes a TRASOP in 1975. The facts and treatment relating to the corporation's qualified investments and investment tax credits for 1975 and 1976 are as follows:

	1975	1976
Facts:		
1. Qualified investment	$500,000	$500,000
2. Credits earned:		
a. 10% credit	50,000	50,000
b. Additional credit	5,000	5,000
c. Carryover of additional credit from prior year, line 5	....	3,000
3. Sec. 46(a)(3) limitation	52,000	47,000
Treatment of credits:		
4. Credits allowed:		
a. Carryover of additional credit	....	3,000
b. Current 10% credit	50,000	44,000
c. Current additional credit	2,000	0
5. Unused credits:		
a. 10% credit	0	6,000
b. Additional credit	3,000	5,000

Thus, in 1975 the section 46(a)(3) limitation ($52,000) is applied first to allow all of the 10-percent investment credit ($50,000). Accordingly only $2,000 of the additional credit earned is allowed in 1975 and $3,000 of the additional credit is carried forward to 1976. In 1976, section 46(a)(1) requires that this $3,000 of additional credit is allowed first, and then only $44,000 of the 10-percent credit earned in 1976 is allowed since the section 46(a)(3) limitation for that year is $47,000. The unused credits from 1976 cannot be carried back since 1975, the only prior year, is an unused credit year.

(iv) *Redeterminations increasing credit.* If a corporation's allowable additional credit is increased because of a redetermination, the increase is treated as if it were an unused credit carryover for purposes of paragraphs (c)(1)(ii) and (c)(8)(i) of this section. For purposes of this subdivision (iv), the date of the increase is determined under paragraph (e)(9)(iii) of this section as if it were the date of a reduction. Thus, for example, assume that a calendar-year corporation claims an additional credit of $100,000 in 1978 because of a qualified investment in that year. In 1980, the additional credit attributable to 1978 qualified investment is redetermined to be $110,000. With respect to the 1978 qualified investment, 1980 is also an applicable year to the extent of $10,000. The increased credit is reflected on the employer's return for 1980. The corporation must fund the TRASOP with this $10,000 under paragraph (c)(8) of this section.

(v) *Redeterminations increasing tax liability.* If a corporation's tax liability for a year is increased such that an additional credit carried forward and claimed in a later year is allowable in the earlier year, the claim of the additional credit will be considered timely if it was otherwise timely under this section. Thus, for example, assume that a calendar-year corporation makes qualified investment of $5,000,000 in 1978 but, based on its income tax liability, is unable to use any of the credit until 1979, when the entire $50,000 additional credit can be used. The corporation adopts the TRASOP, elects the full $50,000 credit and funds in a timely manner for tax year 1979. However, as a result of a 1981 redetermination of the 1978 tax liability, the corporation is able to use $30,000 of the additional credit in 1978 and the remaining $20,000 in 1979. The allowable credit for 1978 is increased by $30,000 and the increase is treated as an unused credit carryover, for which the year of redetermination, 1981, is the applicable year. Assuming that no other credits are available, the 1979 credit is reduced from $50,000 to $20,000, and this reduction is taken into account in the redetermination year by offsetting the reduction against amounts due the plan or by deducting the amount of the reduction. The adoption of the TRASOP for 1979, rather than 1978, is considered timely.

(10) *Deductions at expiration of carryover period.* Under paragraph (c)(1)(i) of this section, a corporation that uses no additional credit in the year of a qualifed investment may nonetheless treat the year in which the qualified investment is made as the first applicable year. If the carryover period under section 46(b)(1)(B) expires before the corporation uses the entire additional credit with respect to the qualified investment, contributions attributable to the unused credit are deductible, subject to the limitations of section 404(a), as if made in the taxable year when the carryover period expires. The amount deductible is the dollar amount of the unused credit irrespective of the current value of the securities contributed with respect to the credit.

(d) *Formal plan requirements*—(1) *In general.* To be a TRASOP, a plan must meet the formal requirements of this paragraph (d).

(2) *Plan year.* To be a TRASOP, a plan must specify a plan year that begins with or within the corporation's taxable year.

(3) *Designed to invest primarily in employer securities.* To be a TRASOP, a plan must state that it is designed to invest primarily in employer securities. A TRASOP intended to qualify as an ESOP under § 54.4975–11 must state that it is designed to invest primarily in employer securities. See paragraph (e)(10) of this section concerning the requirement that a plan invest in employer securities on an ongoing basis.

(4) *Separate accounting.* To be a TRASOP, a plan must state that TRASOP securities are to be accounted for separately from any other contributions to the plan.

(5) *Debts and expenses of the TRASOP.* To be a TRASOP, a plan must state

that TRASOP securities cannot be used to satisfy a loan made to the TRASOP or be used as collateral for a loan made to a TRASOP. However, if the plan so provides, to the extent permitted under section 301(d)(13) of the 1975 TRA and paragraphs (e) (6) and (7) of this section, certain amounts may be used for the TRASOP's start-up expenses and administrative expenses.

(6) *Allocation of TRASOP securities*—(i) *General rules.* To be a TRASOP, a plan must provide for the allocation of TRASOP securities under section 301(d)(3) of the 1975 TRA and this subparagraph (6).

(ii) *Timing.* TRASOP securities are allocated as of the last day of the plan year beginning with or within the appropriate applicable year.

(iii) *Participants.* Each employee who is a participant at any time during the plan year for which allocation is made must receive an allocation as of the end of that year even though not then employed by the employer. However, to receive allocations, employees must satisfy the minimum participation requirements of the plan (for example, 1,000 hours of service).

(iv) *Compensation considered.* Under section 301(d)(3) of the 1975 TRA, allocations must be based on the proportion that each participant's compensation bears to all participants' compensation. Compensation in excess of $100,000 must be disregarded in making these allocations. A plan may have a lower stated ceiling on compensation (from $0 to $100,000) and if the plan has such a lower ceiling, compensation in excess of this ceiling must likewise be disregarded. Also, allocations must be based on a participant's compensation while actually employed, not just while actually participating, in the plan year.

(v) *Section 415 priority rule; transitional rule.* For purposes of section 415, this subdivision (v) applies only to limitation years beginning after November 30, 1982. If a TRASOP security is not allocated to a participant's account for a plan year because of section 415 and section 301(d)(3) of the 1975 TRA, no other amount may be allocated for that participant under any defined contribution plan of the same employer after the actual allocation date for that TRASOP plan year, until all unallocated TRASOP securities have been allocated as provided in paragraphs (d)(6) (vi) and (vii) of this section. This subdivision (v) applies to a TRASOP when, under section 415(f)(1)(B), the TRASOP is treated along with an employer's other defined contribution plans as one plan for purposes of section 415.

(vi) *Unallocated amounts.* Under section 301(d)(3) of the 1975 TRA, TRASOP securities unallocated for a plan year to participants' accounts because of section 415 must be allocated proportionately to the accounts of other participants until the addition to the account of each participant reaches the limits of section 415.

(vii) *Suspense account.* If, after these allocations, TRASOP securities remain unallocated, they must be held in an unallocated suspense account under the TRASOP. Any income produced by these securities must also be held in the account. A plan with such an account will not fail to qualify under section 401(a) merely because of the account. In each successive TRASOP plan year (whether or not an applicable year), the unallocated assets are released from this account for allocation on a first-in-first-out basis. They are then allocated to the participants' accounts proportionately under paragraph (d)(6) (i) through (vi) of this section for each later year until no TRASOP securities remain unallocated. Value for this allocation is determined under paragraph (b)(7) of this section as of the date of transfer from the suspense account or, if the special 20-day average rule applies, the value is determined on the basis of the 20 consecutive trading days immediately preceding the date of transfer from the suspense account.

(viii) *Escrow account.* A TRASOP may provide for the establishment of an escrow account instead of a suspense account. The escrow account must satisfy paragraph (d)(6)(vii) of this section. The beneficiary of the escrow account is to be the TRASOP. The corporation may establish the escrow account and contribute stock or cash to it. In such a case, the escrow agent must transfer assets to the plan each year equal to the amount to be allocated proportionately under paragraph (d)(6)(i)–(vi) of this section. Assets held in an escrow account are plan assets.

(ix) *Treatment of certain plan terminations.* To be a TRASOP, a plan must provide that, if a plan terminates because the corporation ceases to exist, unallocated amounts described in paragraph (d)(6)(vi) of this section must be allocated to the extent possible under section 415 for the year of termination. The remaining unallocated amounts must then be withdrawn. These unallocated amounts are treated as recaptured under all the rules of paragraph (e)(9)(vii) of this section except its last sentence. See paragraph (d)(9)(i) of this section concerning distributions of allocated TRASOP securities.

(x) *No integration.* No TRASOP may be integrated, directly or indirectly, with contributions or benefits under title II of the Social Security Act or any other state or federal law.

(xi) *Fractional securities.* Participants' accounts are to be allocated fractional securities or fractional rights to securities.

(xii) *Accounting for amounts withheld by employer or paid by plan as start-up or administrative expenses.* An employer may withhold certain start-up and administrative expenses from TRASOP securities due the plan. Also, a plan may reduce amounts to be allocated to the extent that certain plan assets are used to reimburse the employer, for example for salaries of employees providing services to the plan, or to pay fees directly to independent contractors for expenses. These expenses do not reduce the amount of additional credit claimed and are not allowable as expenses in computing taxable income. Additional rules concerning these expenses are in paragraphs (e) (6) and (7) of this section.

(7) *Nonforfeitability.* To be a TRASOP, a plan must state that each participant has a nonforfeitable right to allocated TRASOP securities. For purposes of this section, forfeitures described in section 411(a)(3) are not permitted. However, amounts shall not fail to be considered to be nonforfeitable if the plan provides for their return to the corporation—

(i) In the case of conditional contributions, under section 301(d)(14) of the 1975 TRA and paragraph (c)(8)(v) of this section, and

(ii) In the case of investment credit recapture or an event deemed to be a recapture, under section 301(f) of the 1975 TRA and paragraph (f) of this section.

(8) *Voting rights*—(i) *Provision for pass-through.* To be a TRASOP, a plan must state that each participant is entitled to direct a designated fiduciary how to exercise any voting rights on TRASOP securities allocated to the account of the participant. The plan need not permit participants to direct the voting of unallocated TRASOP or other securities held by the trust. It may authorize the designated fiduciary to exercise voting rights for unallocated securities.

(ii) *Notification by the employer.* To be a TRASOP, the plan must obligate the corporation to furnish the designated fiduciary and participants with notices and information statements when voting rights are to be exercised. The time and manner for furnishing participants with a notice or information statement must comply with both applicable law and the corporation's charter and bylaws as generally applicable to security holders. In general, the content of the statement must be the same for plan participants as for other security holders.

(iii) *Fractional securities.* To be a TRASOP, the plan must allow the participants to vote any allocated fractional securities or fractional rights to securities. This requirement is met if the designated fiduciary votes the combined fractional securities or rights to the extent possible to reflect the direction of the voting participants.

(iv) *Unexercised voting rights.* To be a TRASOP, the plan may not permit the designated fiduciary to exercise voting rights which a participant fails to exercise. However, the plan may permit the solicitation and exercise of participants' voting rights by management and others under a proxy provision applicable to all security holders.

(9) *Distributions*—(i) *In general.* To be a TRASOP, a plan must permit the distribution of allocated TRASOP securities only as provided under section

301(d)(4) of the 1975 TRA. Also, under §1.401–1(b)(1)(i) of this chapter, to the extent that a TRASOP is a money purchase pension plan, it can only provide for a distribution in the case of separation from service, death, or disability. No TRASOP may provide for the distribution of TRASOP securities upon plan termination within the 84–month holding period. For purposes of section 301(d)(4) of the 1975 TRA, the 84–month holding period begins on the date as of which TRASOP securities are allocated.

(ii) *Certain fractional securities.* A stock bonus TRASOP may distribute cash instead of fractional securities.

(e) *Operational plan requirements*—(1) *General rule.* To be a TRASOP, a plan in operation must meet the requirements of this paragraph (e). However, the provisions under paragraph (e)(8) of this section apply only to TRASOPs qualified under section 401(a).

(2) *Compliance with plan provisions.* To be a TRASOP, a plan must operate in compliance with its provisions. Failure to operate in compliance with plan provisions constitutes an operational failure to comply. See paragraph (h)(5)(iii) of this section.

(3) *Compliance with certain Code provisions.* To be a TRASOP, a plan must meet the requirements of section 301(d)(7) of the 1975 TRA. Thus, whether or not it is qualified under section 401(a), a TRASOP must meet the requirements of section 401(a) with respect to allocations, section 410 with respect to participation, and section 415 with respect to limitations on contributions and benefits. However, these requirements are modified by paragraph (d)(6) of this section, relating to allocations and section 415.

(4) *Employee contributions.* Under a TRASOP, the participants' receipt of benefits attributable to TRASOP securities contributed for the additional credit (but not the extra additional credit) must not depend on contributions by participants. If a corporation has a plan in existence which requires employee contributions, a portion of the plan may be a TRASOP if employee contributions are not required with respect to that portion of the plan.

(5) *Controlled group of corporations, etc.* Whether or not a TRASOP is qualified under section 401(a), all employees who by reason of section 414 (b) and (c) are treated as employees of an electing corporation are treated as employed by the corporation in determining whether the plan satisfies the requirements of sections 301(d)(7) (B) and (C) of the 1975 TRA. A member of a controlled group under paragraph (b)(4)(i) of this section with a qualified investment but with no actual employees may obtain an additional credit even though the only participants in the corporation's TRASOP are actually employed by another member of the controlled group.

(6) *Start-up expenses*—(i) *In general.* For purposes of this section, the term ''start-up expense'' means any ordinary and necessary amount of a nonrecurring nature paid or incurred by the corporation or by the plan in connection with the establishment of a TRASOP under paragraph (c)(7) of this section. Thus, for example, start-up expenses may include expenses relating to: the drafting or amending of plan documents to establish a TRASOP under section 301(d) or (e) of the 1975 TRA, the seeking of agency approval for these documents and related transactions, the obtaining of shareholder approval for establishing a TRASOP, and the registering of securities for initial funding of a TRASOP.

(ii) *Treatment of start-up expenses.* Start-up expenses may be withheld by the employer from amounts that would otherwise be due the plan under paragraph (c)(8) of this section, to the extent that these amounts are known by the employer when funding first occurs for an applicable year. To the extent that these amounts are not withheld by the employer, the plan may pay remaining amounts from plan assets within a reasonable time after the amounts are known by the plan.

(iii) *Ceiling on start-up expenses.* Reimbursement for start-up expenses is limited to a ceiling. This ceiling is the sum of 10 percent of the first $100,000 that an employer is first required to transfer under paragraph (c)(8) of this section for an applicable year and 5 percent of that amount in excess of $100,000. If this first year is an unused credit year from which there is a carryover, amounts required to be transferred in subsequent years for claiming carryovers from this first year are considered in determining this ceiling. Thus, for example, assume that a calendar-year corporation first earns an additional credit in 1977 of $9,000 and that $3,000 of this amount is claimed on the income tax return for 1977, for 1978 and for 1979. The corporation's ceiling on start-up expenses is $300 when its 1977 return is filed. The total ceiling increases to $600 when its 1978 return is filed and to $900 when its 1979 return is filed, with the claiming of an additional $3,000 credit for each of the three years.

(iv) *Special rule for taxable years ending before January 1, 1977.* Special treatment is available for expenses paid or incurred before January 1, 1977, that were not taken into account in the manner provided by section 301(d)(13) of the 1975 TRA. These expenses may be withdrawn under paragraph (e)(9)(vii) of this section in the same manner as reductions in the corporation's additional credit caused by a recapture. This withdrawal may only be made during the first taxable year ending after March 20, 1979. It is subject to the ceiling of section 301(d)(13) of the 1975 TRA. Expenses previously deducted by a corporation must be reduced on a timely-filed amended return by the amount of this withdrawal.

(7) *Administrative expenses*—(i) *In general.* For purposes of this section, the term ''administrative expense'' means any amount, other than a start-up expense, paid or incurred by the corporation or by the plan that is ordinary and necessary in maintaining the TRASOP. Thus, for example, administrative expenses may include expenses relating to: compensating plan fiduciaries and administrators, leasing office space and equipment, reproducing and mailing information to participants and beneficiaries, and filing reports, returns, and amendments relating to a TRASOP. Paragraph (e)(6) (ii) and (iv), relating to treatment of start-up expenses and to a special rule for taxable years ending before January 1, 1977, also applies to administrative expenses.

(ii) *Ceiling on administrative expenses.* Reimbursement for administrative expenses under paragraph (e)(6)(ii) of this section is limited to the smaller of two amounts for each plan year. The first amount is $100,000. The second amount is the sum of 10 percent of the first $100,000 of dividend income paid with respect to TRASOP securities held by the plan during the plan year ending with or within the corporation's taxable year and 5 percent of any such dividend income in excess of $100,000.

(8) *TRASOP qualification under section 401(a)*—(i) *Permanence.* A TRASOP is not required to be a qualified plan under section 401(a). However, to meet the requirements of section 401(a), a TRASOP must be a permanent plan, as described in §1.401–1(b)(2) of this chapter. Under section 401(a)(21), a plan will not fail to be considered permanent merely because the amount of employer contributions under the plan is determined solely by reference to the amount of additional credit allowable under this section. Thus, for example, it will not fail to be considered permanent merely because employer contributions are not made for a year for which an additional credit is not available by reason of no qualified investment for which an additional credit can be obtained. Section 401(a)(21) applies only to the extent the TRASOP is funded with TRASOP securities and cash in lieu of TRASOP securities.

(ii) *Partial discontinuance of contributions.* A plan that meets the requirements of section 401(a) may receive contributions of TRASOP securities as well as other contributions. If the other contributions continue on a permanent basis, the plan's qualification under section 401(a) will not be adversely affected merely because TRASOP securities cease to be contributed to it. The discontinuance of TRASOP contributions does not alter the requirement that past TRASOP contributions remain invested in employer securities. See paragraph (e)(10) of this section.

(iii) *Income distribution.* Income paid with respect to employer securities acquired by a TRASOP may be distributed at any time after receipt by the plan to participants on whose behalf such securities have been allocated without adversely affecting the qualified status of the plan under section 401(a). (See the last sentence of section

803(h), Tax Reform Act of 1976.) However, under a TRASOP that is a stock bonus or profit-sharing plan, income held by the plan for a 2-year period or longer must be distributed under rules generally applicable to stock bonus and profit-sharing plans qualified under section 401(a). Income distributed by a TRASOP is not subject to the partial exclusion of dividends provided in section 116, whether or not the income is held by the plan for two or more years.

(9) *Reductions in investment credit*—(i) *General rule.* Certain reductions in a corporation's investment credit result from either a recapture under section 47 of the corporation's investment credit or a redetermination of the allowable credit. If these reductions are taken into account under a TRASOP, the plan may only use one or more of the methods described in paragraphs (e)(9), (v), (vi), and (vii) of this section for taking into account these reductions. Thus, for example, more than one method is permitted upon a recapture with respect to a qualified investment made in a particular year. However, the method described in paragraphs (e)(9)(vii) of this section applies only to a recapture and not to a redetermination.

(ii) *Ratable reduction.* A reduction is allocated ratably between the 10-percent credit and the additional credit. Thus, for example, if a calendar-year corporation claims a $33,000 investment credit for 1976, including $3,000 additional credit, and $11,000 of the total credit is recaptured in 1978, the $3,000 additional credit is reduced by $1,000. This subdivision (ii) does not apply to a reduction solely of the additional credit as could occur, for example, in the case of a redetermination caused by a mathematical error in computing the additional credit or in the case of a recapture caused by a bad faith failure to comply under paragraph (h) of this section.

(iii) *Date of reduction.* A reduction in investment credit occurs under this paragraph (e)(9) on the earliest of these dates: (A) The date an income tax return (or an amended return) is filed reflecting the reduction; (B) the date a judicial determination affecting the amount of the reduction becomes final; and (C) the date specified in a closing agreement made under section 7121 that is approved by the Commissioner. For purposes of this subdivision (iii), a judicial determination becomes final at the time prescribed in §1.547–2(b)(1) (ii) or (iii), relating to personal holding company tax.

(iv) *Year for taking reduction into account.* A reduction in investment credit must be taken into account in the earliest year or years possible under the applicable method beginning no later than the year in which the date of the reduction falls.

(v) *Decrease future contributions.* The reduction may be taken into account as a decrease in the value of TRASOP securities to be transferred to the plan. The amount of the decrease is equal to the dollar amount of the reduction.

(vi) *Deduct under section 404.* On the date of the reduction, the amount of the reduction may be treated as an amount paid to the TRASOP for purposes of, and as a deduction to the extent allowed under, section 404.

(vii) *Withdraw TRASOP securities.* If an additional credit allowed for a taxable year is recaptured, the corporation may withdraw from the plan TRASOP securities transferred to, or acquired by, the plan for claiming that year's credit. The withdrawal must only be from assets segregated under paragraph (f)(2) of this section and must be first from assets accounted for in an unallocated suspense account for the particular year. The amount of assets actually withdrawn bears the same proportion to the amount of assets subject to withdrawal as the amount of additional credit recaptured bears to the amount of additional credit claimed. Thus, for example, if the assets subject to withdrawal consist of 300 shares of one class of employer stock and one-third of the additional credit is recaptured, 100 shares of the stock are withdrawn. However, if the current value of the assets subject to withdrawal exceeds the dollar amount of the additional credit claimed, assets may be withdrawn only to the extent that their current value does not exceed the dollar amount of the recaptured portion of the additional credit. Thus, for example, if the 300 segregated shares in the prior example have a current value of $9,000 and the dollar value of the additional credit claimed is $4,500, when one-third of the additional credit is recaptured, only 50 shares, not 100 shares, are withdrawn. Current value is determined under paragraph (b)(7) of this section as of the withdrawal date or, if the special 20-day average rule is applied, it is based on the 20 consecutive trading days immediately preceding the withdrawal date. Withdrawals from an individual's account for the year with respect to which recapture occurs must bear the same ratio to the total amount withdrawn for that year as the individual's TRASOP account balance for that year bears to the total TRASOP account balances for that year. In the case of a TRASOP security acquired after March 20, 1979, the corporation may not withdraw it unless the plan meets the requirements of paragraph (d)(7)(ii) of this section when the plan acquires the TRASOP security.

(viii) *Prior distribution rule.* If a TRASOP distributes an amount allocated with respect to an investment credit for a taxable year and the credit for that year is later recaptured, withdrawals may not reduce participants' accounts below the level to which they would have been reduced had the prior distribution not occurred. Recaptured amounts above this level may only be deducted under paragraph (e)(9)(vi) of this section. They may not be used to decrease future contributions under paragraph (e)(9)(v).

(ix) *Illustration.* The operation of paragraph (e)(9)(viii) of this section is illustrated as follows:

Example. For 1977, a calendar-year corporation claims an additional credit of $10,000. The corporation's TRASOP meets the requirements of section 301(f) of the 1975 TRA. Each of 10 participants under the plan for that year receives an equal allocation of 10 shares valued at $1,000. In 1978, one participant terminates employment and receives a distribution of 10 shares. In 1979, a recapture reduces the 1977 additional credit by $2,000. The value of employer securities has not changed from the allocation date. If the 10 shares had not been distributed, 20 shares would be available for withdrawal, 2 shares from each participant's account. Since 9 participants remain from 1977, only 18 shares are available for withdrawal (2 shares × 9 remaining participants). If these 18 shares are withdrawn, the corporation may take into account 2 shares by deducting their value to the extent permitted under paragraph (e)(9)(vi) of this section.

(10) *Continued investment in employer securities.* The requirement that a plan be designed to invest primarily in employer securities is a continuing obligation. Therefore, a transaction changing the status of a corporation as an employer may require the conversion of certain plan assets into other securities. See paragraphs (d)(9) and (g)(6) of this section. In general, cash or other assets derived from the disposition of employer securities must be reinvested in employer securities not later than the 90th day following the date of disposition. However, the Commissioner may grant an extension of the period for reinvestment in employer securities depending on the facts and circumstances of each case.

(f) *Section 301(f) withdrawals*—(1) *In general.* No assets may be withdrawn by a corporation under section 301(f) of the 1975 TRA unless the assets are either TRASOP securities or plan assets into which TRASOP securities have been converted (''withdrawal assets''). See paragraph (e)(10) concerning restrictions on investment of TRASOP assets in assets other than employer securities. Withdrawal assets must meet the segregated accounting requirements of this paragraph. The physical segregation of assets is not required.

(2) *Segregated accounting.* The segregated accounting requirements are that—

(i) Withdrawal assets must be segregated from other plan assets on a taxable-year-by-taxable-year basis; and

(ii) Separate accounts must be maintained on a taxable-year-by-taxable-year basis for each participant on whose behalf withdrawal assets are allocated.

(3) *Aggregate plan year accounting.* Withdrawal assets for taxable years beginning before October 4, 1976, also meet the segregated accounting requirements if they are aggregated and accounted for in one separate account apart from withdrawal assets in separate accounts for later taxable years.

(g) *Requirements for employer securities*—(1) *General rules.* The term ''employer security'' does not include stock rights, warrants and options. An employer security that is not common stock must at all times be immediately convertible into common stock that is an employer security at a conversion price which is no greater than the fair market value of that common stock at the time the plan acquires the security.

(2) *Common stock*—(i) *In general.* To be an employer security, common stock must meet certain voting power and dividend right requirements. For purposes of this paragraph (g), stock held by the TRASOP is not treated as outstanding.

(ii) *Dividend right limitations.* If dividend rights are subject to a limitation, then stock representing at least 50 percent of the fair market value of the employer's outstanding common stock at the time the common stock is transferred to or purchased by the TRASOP must be subject to the same limitation. However, common stock that satisfies paragraph (g)(3)(ii) of this section is not subject to this subdivision (ii).

(3) *Voting power and dividend rights.* To be an employer security, common stock must have voting power and dividend rights which, when taken together, are "no less favorable" than the voting power and dividend rights of any other common stock issued by the employer. Common stock which meets one of the following tests is "no less favorable".

(i) *Ten-percent shareholder test.* The stock is part of, or identical to, a class of outstanding stock of which at least 50 percent is not owned by 10-percent shareholders. For this purpose, a 10-percent shareholder is one who owns at least 10 percent of the outstanding shares in a class, including shares constructively owned under section 318.

(ii) *Substantial proportionality test.* More than one class of common stock is outstanding and an identical percentage of shares from each class is transferred to the TRASOP.

(iii) *Voting power test.* The stock is part of, or identical to, the existing class of stock having the greatest number of votes per unit of fair market value. For example, assume there are only two classes of common stock, Class A and Class B. Their fair market values per share are $1 and $.50, respectively, and the owner of each share of each class is entitled to one vote per share. Thus, Class B has two votes per $1 and Class A has one vote per $1. Accordingly, the Class B stock has the greatest number of votes per unit of fair market value.

(4) *Right of first refusal.* TRASOP securities may, but need not, be subject to a right of first refusal. However, whether or not the plan is an ESOP, any such right must meet the requirements of § 54.4975–7(b)(9) of this chapter.

(5) *Put option.* A TRASOP security that is transferred to a TRASOP after September 30, 1976, must be subject to a put option if it is not publicly traded when distributed or if it is subject to a trading limitation when distributed. The provisions of § 54.4975–7(b)(10)–(12) and § 54.4975–11(a)(3) of this chapter apply to such securities whether or not the plan is an ESOP.

(6) *Change of employer security status.* In general, a transaction changing the status of a corporation as an employer, or as a member of a controlled group of corporations including the employer, adversely affects the status as employer securities of common stock and securities held by a plan ("old employer securities"). However, to the extent that the transaction causing the change in status of the old employer securities does not result in a recapture under section 47 of any investment credit underlying the transfer to, or acquisition by, the plan of the old employer securities, common stock and securities ("new employer securities") substituted for old employer securities are treated as if they were the old employer securities if—

(i) The plan is not terminated,

(ii) The old employer securities and the new employer securities are of equal value at the time of the transaction changing the status of the old employer securities, and

(iii) The new employer securities otherwise meet the requirements of this section.

(h) *Failure to comply*—(1) *General rule*—(i) *Effect of failure.* If a corporation elects under paragraphs (c)(2) through (5) of this section to obtain an additional credit and fails to comply with respect to that credit at any time, it is liable to the United States for a civil penalty equal to the amount involved in the failure to comply. If the corporation fails to comply with respect to an additional credit during the 84-month period described in section 301(d)(4) of the 1975 TRA, the credit is also recaptured. A separate failure to comply occurs for each taxable year in which a failure continues to exist.

(ii) *Illustration of continuing failure's effect.* Assume that in 1975 an additional credit is allowed and a failure to comply occurs in 1975 with respect to that credit. Assume also that in 1976 the 1975 failure continues uncorrected, another additional credit is allowed, and a failure to comply occurs with respect to the 1976 credit. Under these circumstances, on the last day of 1976 three separate failures to comply exist: (A) The 1975 failure with respect to the 1975 credit, (B) the 1976 failure with respect to the 1975 credit, and (C) the 1976 failure with respect to the 1976 credit.

(2) *Assessment and collection.* The civil penalty must be assessed and collected in the same manner in which a deficiency in the payment of federal income tax is assessed and collected.

(3) *Exception.* If a failure to comply is corrected within the correction period described in paragraph (h)(5) of this section—

(i) The corporation is not liable for a civil penalty; and

(ii) If the corporation establishes that at the time of the failure a good faith effort to comply was made, its additional credit is not disallowed.

(4) *Failure to comply (penalty classifications)*—(i) *In general.* An electing corporation fails to comply if a defect described in paragraphs (h)(4) (ii) through (iv) of this section occurs with respect to an additional credit allowed for a particular taxable year. The characterization of the defect in this subparagraph (4) determines the amount involved under paragraph (h)(8) of this section for the purpose of assessing the civil penalty.

(ii) *Funding defect.* A funding defect occurs if a corporation or its TRASOP fails to satisfy the requirements of paragraph (c) (8) or (9) of this section, relating to funding a TRASOP and claiming an additional credit.

(iii) *Special operational defect.* A special operational defect occurs if a TRASOP fails in operation to satisfy the requirements described in paragraphs (d) (5) through (9) of this section, relating to debts and expenses of a TRASOP, allocation of TRASOP securities, nonforfeitability, voting rights, and distributions, or paragraph (e)(3) of this section, relating to compliance with certain Code provisions.

(iv) *De minimis defect.* A de minimis defect occurs if a corporation or its TRASOP fails to satisfy any requirement of this section other than those enumerated either in paragraph (h)(4) (ii) and (iii) of this section or in paragraphs (a)(2) and (c) (2) through (5) of this section. A failure to comply under this subdivision (iv) may be formal or operational in nature.

(5) *Failure to comply (correction rules classifications)*—(i) *In general.* If for an electing corporation a defect described in paragraph (h)(4) of this section occurs, the procedure for correcting the failure to comply depends upon whether the failure is classified as a ''formal'' failure or an ''operational'' failure under this subparagraph (5).

(ii) *Formal failure to comply.* Formal failures are corrected by retroactive amendment. If a formal plan requirement is not met, the plan must be retroactively amended by no later than the expiration of the correction period under paragraph (h)(6) of this section. A plan fails to meet a formal plan requirement of paragraph (d) of this section if, for example, it does not state, as required by paragraph (d)(3) of this section, that it is designed to invest primarily in employer securities.

(iii) *Operational failure to comply.* Operational failures are corrected by undoing the defective transaction and by making the plan and the participants whole. If the value of TRASOP securities transferred to the TRASOP is less than the amount of the additional credit, the corporation must make up any resulting funding deficiency within the correction period. This is done, for example, by contributing additional TRASOP securities plus an amount equal to the dividends or interest that would have been paid between the time that the TRASOP securities should have been transferred and the actual time for the transfer. The contribution of additional

TRASOP securities is based on their value under paragraph (b)(7) of this section as of the date by which they were required to be transferred to the plan. An electing corporation fails to meet an obligation undertaken under this section if, for example, it fails to comply with paragraph (c)(8) of this section.

(6) *Correction period*—(i) *In general.* For purposes of this paragraph (h), the ''correction period'' begins when the failure to comply occurs and ends 90 days after receipt by the corporation of a notice of deficiency under section 6212 with respect to the civil penalty and the investment credit.

(ii) *Extensions of correction period.* Extensions of the correction period are determined under § 53.4941(e)–1(d)(2) (i), (ii), and (iv) of this chapter (Foundation Excise Tax Regulations). For this purpose, a failure to comply is treated as an act of self-dealing, the corporation is treated as a foundation, and a civil penalty is treated as a tax under section 4941(a)(1).

(7) *Good faith.* The corporation has the burden of establishing under paragraph (h)(3)(ii) of this section that it made a good faith effort to comply. For example, if a corporation shows that it has made a good faith effort to establish the fair market value of the employer securities transferred to the TRASOP, it may be entitled to the additional credit even if, on later examination of the return, it is determined that more securities should have been transferred. For purposes of this paragraph (h)(7), reasonable reliance on Technical Information Release 1413 (1975–50 I.R.B. 16), questions and answers relating to ESOP's, is a good faith effort to comply.

(8) *Amount involved*—(i) *In general.* The amount involved in a failure to comply is an amount described in this subparagraph (8). A maximum amount and a minimum amount are determined with respect to an additional credit allowed for a particular taxable year.

(ii) *Maximum amount involved.* Notwithstanding any other rule in this paragraph (h), all amounts involved with respect to an additional credit allowed for a particular taxable year may not exceed the amount of that credit.

(iii) *Minimum amount involved.* The minimum amount is ½ of one percent of the additional credit times the number of full months, or parts of full months, during which the failure to comply exists. ''Full month'' has the meaning assigned in § 1.1250–1(d)(4) (realty depreciation recapture).

(iv) *Funding amount involved.* The amount involved for a funding defect is the greater of the minimum amount involved or the amount required to place the plan in the position it would have been in if no funding defect had occurred.

(v) *Special operational amount involved.* The amount involved for a special operational defect is the maximum amount involved.

(vi) *De minimis amount involved.* The amount involved for a de minimis defect is the minimum amount involved.

(9) *Certain permissible actions*—(i) *Elections prior to January 19, 1979.* A corporation does not fail to comply (within the meaning of this paragraph (h)) merely because it revokes an election made prior to January 19, 1979, under the general rule described in paragraph (c)(1)(i) of this section and with respect to which no additional credit was claimed in the taxable year for which the election was made. Such a revocation is permitted irrespective of whether the carryover option described in paragraph (c)(1)(ii) is elected with respect to qualified investment made in a year for which a general rule election is revoked.

(ii) *Pro rata use of credit.* A corporation does not fail to comply merely because, for an applicable year ending prior to January 19, 1979, it provides for pro rata use of the regular 10-percent credit and the 1-percent additional credit to the extent that less than all of a taxpayer's credit earned for a taxable year is allowable.

(iii) *Transitional rule.* The Commissioner, based on the particular facts and circumstances of individual cases, may determine that a good faith failure to comply before January 19, 1979, with a final or temporary rule adopted under this section on or after that date does not require retroactive correction under paragraph (h)(5)(ii) of this section.

(Sec. 301(d)(2)(C) of the Tax Reduction Act of 1975; sec. 7805 of the Internal Revenue Code of 1954 (89 Stat. 38, 68A Stat. 917; 26 U.S.C. 7805))

[T.D. 7857, 47 FR 54795, Dec. 6, 1982]

§ 1.46–9 Requirements for taxpayers electing an extra one-half percent additional investment credit.

(a) *Introduction*—(1) *In general.* A corporation that qualifies for an additional credit under § 1.46–8 may elect under section 46(a)(2)(B)(ii) of the Code to obtain an extra one-half percent additional investment credit for property described in section 46(a)(2)(D). Paragraph (c) of this section provides additional procedures for electing this extra credit. This section also provides rules for implementing an employee stock ownership plan that meets the requirements of sections 301 (d) and (e) of the Tax Reduction Act of 1975 (''1975 TRA''). The plan must meet the additional formal requirements of paragraph (d), and the additional operational requirements of paragraph (e) of this section. Unless otherwise indicated, statutory references in this section are to the Internal Revenue Code of 1954, as applicable for the year in which a qualified investment is made.

(2) *Applicability of one-percent TRASOP provisions.* Subject to the exceptions and additional rules of this section, the provisions of § 1.46–8 apply to an election made, and to a plan implemented, under this section. However, this section does not change the requirements of § 1.46–8 for purposes of obtaining an additional one-percent credit.

(3) *Effective date.* This section applies only to taxable years beginning after December 31, 1976. See section 803(j)(2)(A) of the Tax Reform Act of 1976.

(b) *Definitions*—(1) *One-percent terms.* When used in this section, the terms listed below have the same meanings as in § 1.46–8(b):

(i) TRASOP. See § 1.46–8(b)(1).

(ii) Employer. See § 1.46–8(b)(3).

(iii) Employer securities. See § 1.46–8(b)(4).

(iv) TRASOP securities. See § 1.46–8(b)(5).

(v) Publicly traded. See § 1.46–8(b)(6).

(vi) Value. See § 1.46–8(b)(7).

(vii) Compensation. See § 1.46–8(b)(8).

(2) *Additional credit.* An ''additional credit'' or ''extra additional credit'' is the extra one-half percent additional investment credit under section 46(a)(2)(B)(ii)—

(i) For purposes of applying this section, and

(ii) When the context requires, for purposes of applying § 1.46–8 to this extra credit.

(3) *Matching employee contribution.* A ''matching employee contribution'' is a contribution that meets the requirements of paragraph (f) of this section.

(4) *Basic amount.* A ''basic amount'' is a matching employee contribution which is equal to the maximum credit multiplied by a fraction. The numerator of this fraction is a participant's compensation for the plan year. (See § 1.46–9(f)(3)(ii), concerning disregarded compensation.) The denominator is the aggregate of all participants' compensation for the plan year. The ''maximum credit'' is the estimated value of all employer contributions under paragraph (c)(4)(i) of this section for the applicable year, determined as if the maximum possible matching employee contributions were made.

(5) *Supplemental contribution.* A ''supplemental contribution'' is a matching employee contribution made in addition to a basic amount.

(c) *Special procedures for extra additional credit*—(1) *Statement of election.* A corporation's statement of election described in § 1.46–8(c)(3) must contain the name and taxpayer identification number of the corporation. Also, it must declare in the following words, or in words having substantially the same meaning, that:

(i) The corporation elects to have section 46(a)(2)(B) (i) and (ii) of the Internal Revenue Code of 1954 apply; and

(ii) The corporation agrees to implement (or continue to implement, as appropriate) a TRASOP and to claim the additional credit as required by § 1.46–8 and § 1.46–9 of the Income Tax Regulations.

(2) *Separate election.* A separate election must be made for each year's qualified investment to obtain the extra additional credit for the qualified

investment. If a corporation does not make a timely election to obtain an extra additional credit for a taxable year, it may not subsequently make the election on an amended return or otherwise.

(3) *No partial election.* To reduce administrative costs, a plan may establish a ceiling on matching employee contributions. Thus, for example, it may provide for the contribution of only a basic amount without supplemental contributions under paragraph (f)(2)(iv) of this section. Such a ceiling that in effect limits the additional credit to less than one-half percent of the qualified investment is not a partial election prohibited by §1.46–8(c)(5).

(4) *Funding a TRASOP*—(i) *Employer contributions.* The carryover option under §1.46–8(c)(1)(ii) is available for both the one-percent and one-half percent additional credits or for the one-half percent additional credit alone. In applying §1.46–8(c)(8)(iii), the value of TRASOP securities, other than those acquired with matching employee contributions, for an applicable year must equal one-half percent of the corporation's qualified investment for that year or, if less, the amount of matching employee contributions received (including pledges, where permitted by the plan) by the time the election for that year is made. However, if a corporation exercises the carryover option in §1.46–8(c)(1)(ii), the value of these TRASOP securities for an applicable year must equal the amount of additional credit claimed for that year determined after being reduced, if necessary, to equal contributions received (including pledges, if permitted) by the time the credit is claimed for that year. The value of these TRASOP securities, but not the amount of credit claimed, is further reduced to the extent that the employer withholds TRASOP securities to take into account start-up and administrative expenses under paragraph (e)(1) of this section or an investment tax credit reduction under paragraph (e)(2) of this section.

(ii) *Employee contributions.* Paragraph (f)(4) of this section, but not §1.46–8(c)(8) (i) through (iii), applies to TRASOP securities acquired with matching employee contributions.

(5) *Claiming additional credit.* In applying §1.46–8(c)(9)(ii), if less than all of a corporation's credit earned for a taxable year is allowed, the extra additional credit under this section for that year is allowed last.

(d) *Additional formal plan requirements*—(1) *Contributions by employees*—(i) *In general.* The plan must contain statements relating to matching employee contributions as required under paragraph (f) of this section.

(ii) *Aggregate floor.* A plan may provide for the return of all matching employee contributions for a year if the aggregate amount of such contributions is not at least equal to an amount stated in the plan. See also §1.46–9(f)(3)(iv).

(2) *Separate accounting.* The plan must state that employer contributions and matching employee contributions respectively described in paragraph (c)(4)(i) and (ii) of this section are accounted for separately from each other as well as from other contributions, including those described in §1.46–8(c)(8).

(3) *Allocation of TRASOP securities contributed by employer.* The plan must provide for the allocation under section 301(e)(5) of the 1975 TRA and this subparagraph (3) of TRASOP securities contributed by the employer. These allocations reflect a ratable reduction for TRASOP securities withheld by the employer under paragraph (c)(4)(i) of this section. TRASOP securities so allocated are deemed to be allocated under section 301(d) of the 1975 TRA. In applying §1.46–8(d)(6) to this section, only subdivisions (ii), (iv), (ix), (x), (xi) and (xii) thereof apply to allocations under this section.

(4) *Effect of section 415.* In applying the limitations of section 415 to limitation years beginning after January 19, 1979, allocations of TRASOP securities are considered in the following order: first, allocations under §1.46–8; second, allocations under this section. See §1.46–8(d)(6)(v) concerning the allocation of amounts under any other defined contribution plan. No suspense or escrow account may be maintained to hold contributions under this section that are unallocated because of section 415. Thus, section 415 in effect limits the availability of an extra additional

credit in a particular year. However, if the plan so provides, a potential extra additional credit is treated as an investment credit carryover under the carryover option described in §1.46–8(c)(1)(ii) to the extent that it is not used in a particular year because of section 415.

(5) *Nonforfeitability*. Employer contributions are also not considered to be forfeitable under §1.46–8(d)(7) merely because the plan provides for their return to the corporation in an amount equal to the excess of employer contributions under this section over matching employee contributions or in the case of discriminatory operation under paragraph (f)(3) of this section. See paragraph (f)(3)(iv).

(6) *Distributions*. Notwithstanding §1.46–8(d)(9)(i), a plan may not distribute from a participant's employer contribution account cash or employer securities attributable to unpaid pledges of the participant.

(e) *Additional operational plan requirements*—(1) *Start-up and administrative expenses*—(i) *In general*. The expense of establishing plan features relating to the extra additional credit is a start-up expense. The expense of collecting matching employee contributions is an administrative expense.

(ii) *Payment*. Under §1.46–8(e) (6) and (7), an employee may withhold or a plan may use, to the extent not withheld, TRASOP securities for start-up and administrative expense payments. However, withdrawals must be either limited to employer contributions under §1.46–8(c)(8) or reasonably apportioned between these employer contributions and contributions under paragraph (c)(4)(i) of this section. An example of reasonable apportionment is earmarking expenses attributable to each of the additional credits and allocating any remaining non-earmarked expenses on either a 2:1 or 1:1 ratio between the additional credits. Another example is simply apportioning expenses between the additional credits on a 2:1 or 1:1 ratio basis without earmarking. However, if one-percent and one-half percent start-up expenses are attributable to different qualified investments, withdrawals for one-half percent expenses are limited to employer contributions under paragraph (c)(4)(i) of this section.

(iii) *Ceiling*. In determining the ceiling on start-up expenses under §1.46–8(e)(6)(iii), only employer contributions under §1.46–8(c)(8) and paragraph (c)(4)(i) of this section are considered. In determining the ceiling on administrative expenses under §1.46–8(e)(7)(ii), dividends on all TRASOP securities, including those acquired with matching employee contributions, are considered.

(2) *Redeterminations and recaptures*. A reduction in investment credit because of a redetermination or recapture is allocated ratably under the principles of §1.46–8(e)(9)(ii) among the 10-percent credit, the one-percent credit, and the one-half percent credit for a particular year. However, as illustrated in §1.46–8(e)(9)(ii), this subparagraph (3) does not apply to a redetermination solely of one or both of the additional credits.

(3) *Withdrawal asset segregation*. The segregated accounting provisions of §1.46–8(f) apply independently to withdrawal assets attributable to TRASOP securities under §1.46–8 and to TRASOP securities under this section.

(f) *Matching employee contributions*—(1) *Designation by employee*. The plan must state that each employee on whose behalf an allocation is made under §1.46–8(d)(6) for an applicable year is eligible to designate and contribute an amount to the TRASOP for that year as a matching employee contribution.

(2) *Form and timing of contribution*—(i) *Cash*. A participant may contribute in a manner provide under the plan a designated amount in cash directly to the plan or indirectly by the employer's withholding from amounts otherwise due the participant. The full amount, or pledge in lieu of an amount, for an applicable year must be contributed by the applicable last day described in §1.46–8(c)(8)(i).

(ii) *Optional pledges in lieu of cash*. The plan need not permit a pledge. However, when permitted by the plan, an irrevocable written pledge made in good faith by a participant is treated as a matching employee contribution of cash, whether or not the pledge is in fact contractually binding. The pledge must be to contribute, by no later than a time specified in the TRASOP, a designated amount in cash directly to the plan or indirectly by authorizing the employer to withhold from compensation otherwise due a participant. The specified time may not be later than 24 months after the close of the applicable year for which the amount is treated as a matching employee contribution.

(iii) *Transitional rule.* A plan may provide for the receipt of employee pledges at any time before the later of the applicable last day or January 15, 1980. If the last day for receipt of pledges for an applicable year is January 15, 1980, the one-half percent TRASOP credit for the applicable year may be elected on an amended return filed not later than that date, and employer contributions for the applicable year must be made by that date. A plan may provide that pledges which otherwise would have been payable on or before December 31, 1979 may be paid on or before January 15, 1980.

(iv) *Basic and supplemental contributions.* A plan formula may limit a matching employee contribution to a basic amount. It may also permit matching employee contributions of supplemental amounts to the extent that total basic amount contributions do not equal the amount of the additional credit claimed under this section. Employees may make supplemental contributions covering unpaid pledges only after the employer has disclosed the value of securities and income attributable to the unpaid pledge.

(3) *Prohibited discrimination*—(i) *General rule.* Matching employee contributions must be based on a formula stated in the plan that does not result in prohibited discrimination under section 401(a)(4) either in form or in operation. Thus, for example, a flat dollar amount required as a matching employee contribution to qualify for employer-provided benefits under this section may not be too high for lower paid employees to contribute under the plan. Further, lower paid employees must participate to such an extent that allocations under this section do not result in prohibited discrimination

(ii) *Compensation disregarded.* Compensation disregarded in allocations under §1.46–8(d)(6)(iv) is disregarded under this paragraph and for purposes of determining basic amounts as defined in paragraph (b)(4) of this section.

(iii) *Former employees.* A TRASOP must give all participants a reasonable opportunity to make matching employee contributions. However, neither a former employee who is a participant at the end of the plan year by reason of §1.46–8(d)(6)(iii), nor the estate of a deceased employee, need have the same options as are available to other participants. Thus, for example, a former employee may be limited to cash contributions even though other participants are permitted to make pledges. Also, if former employees of estates of deceased employees fail to make matching employee contributions, they are not considered in determining whether or not a TRASOP is discriminatory.

(iv) *Return of contributions.* A plan may provide for the return of employee and employer contributions for a year to the extent that plan operation would otherwise result in prohibited discrimination.

(4) *Investment in employer securities*—(i) *General rule.* Matching employee contributions must be invested in TRASOP securities no later than 30 days after the time for funding a TRASOP under §1.46–8(c)(8)(ii) or, if later, the time specified under the special rule for pledges.

(ii) *Special rule for pledges.* Cash contributed to pay a pledge permitted by paragraph (f)(2)(ii) of this section must be invested in employer securities so that the cash is not held more than 3 months. The 3-month period includes the period, if any, that the cash is held by the employer.

(5) *Reduction of matching employee contribution*—(i) *In general.* Matching employee contributions must be reduced in three cases. First, they are reduced to the extent that there are no corresponding employer contributions described in paragraph (c)(4)(i) of this section. This occurs, for example, when the aggregate of the basic amounts of matching employee contributions exceeds the allowable credit. Second, they are reduced to the extent that corresponding employer contributions matching them under paragraph (c)(4)(i) of this section are withdrawn

under section 301(f) of the 1975 TRA. Third, they are reduced by the amount of any pledge unpaid at the time specified in paragraph (f)(2)(ii) of this section.

(ii) *Apportioning reductions.* Generally, the account of each contributor under this section for an applicable year is reduced by a percentage of the account. This percentage equals the total reduction of all matching employee contributions for that year divided by the total, before the reduction, of all matching employee contributions. However, if a reduction is directly attributable to a particular contributor, only that contributor's account is reduced. A reduction is directly attributable to a particular contributor when, for example, the limits of section 415 prohibit a full allocation of employer contributions equal to the contributor's matching employee contribution for an applicable year or when a contributor fails to pay a pledge. A reduction may not yield a negative balance in a participant's account.

(iii) *Disposing of reductions.* If a participant's matching employee contribution is reduced, the amount of the reduction must either be treated as a voluntary contribution or returned to the participant by the later of two dates. The first date is 30 days after the time for investing in TRASOP securities under paragraph (f)(4) of this section. The second date is the 30th day after the date on which the withdrawal of employer contributions occurs that causes the reduction. It may be treated as a voluntary contribution only if, as stated in the plan, the participant so indicates in writing when making the matching employee contribution.

(iv) *Supplemental contributions covering unpaid pledges.* Notwithstanding the timing requirements of paragraph (f)(2) of this section, supplemental contributions covering unpaid pledges must be made no later than 60 days after accounting for the corresponding reduction under paragraph (f)(5)(ii) of this section.

(v) *Effect of reduction on credit.* For the purpose of applying section 415 to an additional allocation to the account of a participant attributable to a supplemental contribution covering an unpaid pledge, the contribution is treated as an annual addition to the supplemental contributor's account in the applicable year for which the reduction occurred. An amount in excess of the contribution may be allocated in equal amounts for each year from the applicable year to the year of the reduction. The employer's credit is reduced only to the extent that a proportionate transfer of assets is not made from the account of the participant to whom the reduction is attributable to the accounts of supplemental contributors.

(vi) *Example.* The rules contained in paragraphs (f) (2) and (5) of this section are illustrated by the following example:

Example. Assume that A is an employee of corporation M, a calendar year taxpayer that maintains a TRASOP. A has pledged $100 as a matching employee contribution for 1977, the first applicable year of M's TRASOP. M has transferred employer securities valued at $100 that have been allocated to A's account under the Plan. The TRASOP provides that pledges must be paid no later then 24 months after the end of the applicable year. Thus, A's $100 pledge must be paid by December 31, 1979. As of December 31, 1979, the employer securities attributable to A's pledge have a value of $90 and have produced undistributed dividend income of $13. Thus, the value of the portion of A's account attributable to the unpaid pledge is $103. After December 31, 1979, the value of this portion of A's account is disclosed to participants, and employee B chooses to pay off A's unpaid pledge, as provided in the plan, by making a $100 supplemental contribution. The full amount of the securities and dividend income attributable to the unpaid pledge are transferred from A's account to that of B as of December 31, 1979. M's credit for 1977 is not reduced. The $100 supplemental contribution is an annual addition to B's account for purposes of applying section 415 in 1979. Income attributable to the pledge in excess of the supplemental contribution, $3 ($103–$100), may be allocated and treated as an annual addition by spreading this excess amount over the years from the applicable year to the year of the reduction (1977, 1978, 1979).

(g) *Failure to comply*—(1) *General rule.* If a corporation elects under § 1.46–8(c) (2) through (5) and paragraph (c)(1) of this section to obtain an additional credit, § 1.46–8(h) (1), (2), (3), (5), (6), and (7) as modified by this paragraph (g) apply.

(2) *Failure to comply (penalty classifications)*—(i) *In general.* A corporation

fails to comply with an extra additional credit election if a defect described in paragraph (g)(2) (ii)–(iv) of this section occurs in a taxable year.

(ii) *Funding defect.* A funding defect occurs under this section if a corporation or its TRASOP fails to satisfy the requirements of §1.46–8(c) (8) or (9) or paragraph (c)(4) of this section, as they apply directly to the extra additional credit.

(iii) *Special operational defect.* A special operational defect occurs if a TRASOP fails in operation to satisfy the requirements decribed in §1.46–8(d) (5) through (9) (except (6) (i), (iii), and (v) through (viii)) or (e)(3), or paragraphs (d) (5), (6), and (e)(3) of this section, as they apply directly to the extra additional credit.

(iv) *De minimis defect.* A *de minimis* defect occurs if a corporation or its TRASOP fails to satisfy the requirements, other than those enumerated in paragraphs (c) (1) and (2) and (g)(2) (ii) and (iii), of this section or of §1.46–8 other than those excluded under §1.46–8(h)(4)(iv).

(3) *Amount involved.* The amount involved in a failure to comply under this section is based upon the extra additional credit within the meaning of section 46(a)(2)(B)(ii).

(4) *Coordination of civil penalties.* The civil penalties under §1.46–8 and this section are determined separately. In no case may the amount involved with respect to a particular failure to comply in one year exceed under both sections the full additional credit within the meaning of section 46(a)(2)(B) (i) and (ii).

[T.D. 7856, 47 FR 54805, Dec. 6, 1982]

§ 1.46–10 [Reserved]

§ 1.46–11 Commuter highway vehicles.

(a) *In general.* Section 46(c)(6) provides that the applicable percentage to determine qualified investment under section 46(c)(1) for a qualifying commuter highway vehicle is 100 percent. A qualifying commuter highway vehicle is a vehicle (defined in paragraph (b) of this section)—

(1) Which is acquired by the taxpayer on or after November 9, 1978,

(2) Which is placed in service by the taxpayer before January 1, 1986, and

(3) With respect to which the taxpayer makes an election under paragraph (g) of this section.

(b) *Definition of commuter highway vehicle.* A commuter highway vehicle is a highway vehicle that meets the following requirements:

(1) The vehicle is section 38 property in the hands of the taxpayer. The rule of section 48(d), allowing a lessor to elect to treat the lessee of new section 38 property as having acquired the property, applies to commuter highway vehicles. If the vehicle is leased and that election is made, the lessee is treated as the taxpayer under this section. However, if that election is not made. the lessor, and not the lessee, is treated as the taxpayer under this section.

(2) The vehicle must meet the seating capacity requirement of paragraph (c) of this section; and

(3) The taxpayer reasonably expects to meet the commuter use requirement of paragraph (d) of this section for at least the first 36 months after the vehicle is placed in service.

(c) *Seating capacity.* A commuter highway vehicle must have a seating capacity of a least 8 adults in addition to the driver's seat.

(d) *Commuter use requirement.* A vehicle meets the commuter use requirement only if at least 80 percent of the miles the vehicle is driven are for trips to transport the taxpayer's employees between their residences and their places of employment. A trip for this purpose includes driving the vehicle before or after employees are in the vehicle, so long as the mileage driven is necessary either to pick up or drop off passengers or to park the vehicle in its regular parking space. A trip does not include miles driven solely for maintenance or to refuel the vehicle. A trip is not considered to transport the taxpayer's employees between their residences and their places of employment unless at least one-half the seating capacity (defined in paragraph (c) of this section) is used to seat employees of the taxpayer. In no event is the driver counted as an employee of the taxpayer.

(e) *Definition of employee.* An employee in this section is the same as in section 3121 (d) (definition of employee for withholding purposes).

(f) *Transportation between employee's residence and place of employment.* An employee is transported between that employee's residence and place of employment even if that place of employment is not the same as any of the other employees transported, and even if picked up or dropped off at some central point between that residence and place of employment. An employee is not transported between that employee's residence and place of employment if the transportation is of the type for which a deduction would be allowed under §1.162–2 were the employee providing it, such as the transportation from one work site to another after beginning work for the day.

(g) *Election.* A taxpayer must elect to have the vehicle treated as a qualifying commuter highway vehicle on the return for the taxable year in which the vehicle is placed in service. The election may be made only if the vehicle actually meets the commuter use requirement under paragraph (d) of this section for that taxable year. It must be made on or before the due date (including extensions) of that return. The election is effective as of that due date.

[T.D. 8035, 50 FR 29370, July 19, 1985]

§1.47–1 Recomputation of credit allowed by section 38.

(a) *General rule*—(1) *In general.* (i) If during the taxable year any section 38 property the basis (or cost) of which was taken into account, under paragraph (a) of §1.46–3, in computing the taxpayer's qualified investment is disposed of, or otherwise ceases to be section 38 property or becomes public utility property (as defined in paragraph (g) of §1.46–3) or is a qualifying commuter highway vehicle (as defined in paragraph (a) of §1.46–11) which undergoes a change in use (as defined in paragraph (m)(2) of this section) with respect to the taxpayer, before the close of the estimated useful life (as determined under subparagraph (2)(i) of this paragraph) which was taken into account in computing such qualified investment, then the credit earned for the credit year (as defined in subdivision (ii)(*a*) of this subparagraph) shall be recomputed under the principles of paragraph (a) of §1.46–1 and paragraph (a) of §1.46–3 substituting, in lieu of the estimated useful life of the property that was taken into account originally in computing qualified investment, the actual useful life of the property as determined under subparagraph (2)(ii) of this paragraph. There shall also be recomputed under the principles of §§1.46–1 and 1.46–2 the credit allowed for the credit year and for any other taxable year affected by reason of the reduction in credit earned for the credit year, giving effect to such reduction in the computation of carryovers or carrybacks of unused credit. If the recomputation described in the preceding sentence results in the aggregate in a decrease (taking into account any recomputations under this paragraph in respect of prior recapture years, as defined in subdivision (ii)(*b*) of this subparagraph) in the credits allowed for the credit year and for any other taxable year affected by the reduction in credit earned for the credit year, then the income tax for the recapture year shall be increased by the amount of such decrease in credits allowed. For treatment of such increase in tax, see paragraph (b) of this section. For rules relating to ''disposition'' and ''cessation'', see §1.47–2. For rules relating to certain exceptions to the application of this section, see §1.47–3. For special rules in the case of an electing small business corporation (as defined in section 1371(b)), an estate or trust, or a partnership, see respectively, §§1.47–4, 1.47–5, or 1.47–6. For rules applicable to energy property, see paragraph (h) of this section. For special rules relating to recomputation of credit allowed by section 38 if progress expenditure property (as defined in §1.46–5(d)) ceases to be progress expenditure property with respect to the taxpayer, see paragraph (g) of this section.

(ii) For purposes of this section and §§1.47–2 through 1.47–6—

(*a*) The term ''credit year'' means the taxable year in which section 38 property was taken into account in computing a taxpayer's qualified investment.

(*b*) The term ''recapture year'' means the taxable year in which section 38 property the basis (or cost) of which was taken into account in computing a taxpayer's qualified investment is disposed of, or otherwise ceases to be section 38 property or becomes public utility property with respect to the taxpayer, before the close of the estimated useful life which was taken into account in computing such qualified investment.

(*c*) The term ''recapture determination'' means a recomputation made under this paragraph.

(2) *Rules for applying subparagraph (1).* For purposes of subparagraph (1) of this paragraph—

(i) In determining whether section 38 property is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the estimated useful life which was taken into account in computing the taxpayer's qualified investment, the term ''estimated useful life'' means the shortest life of the useful life category within which falls the estimated useful life which was assigned to such property under paragraph (e) of §1.46–3. Thus, section 38 property which is assigned, under paragraph (e) of §1.46–3, an estimated useful life of 6 years shall not be treated, for purposes of subparagraph (1) of this paragraph, as having been disposed of before the close of its estimated useful life if such property is sold 5 years (that is, the shortest life of the 5 years or more but less than 7 years useful life category) after the date on which it was placed in service. Likewise, section 38 property with an estimated useful life of 15 years which is placed in service on January 1, 1972, shall not be treated as having been disposed of before the close of its estimated useful life if such property is sold at any time after January 1, 1979 (that is, 7 years or more after the date on which it was placed in service).

(ii) In determining the recomputed qualified investment with respect to property which is disposed of or otherwise ceases to be section 38 property the term ''actual useful life'' means, except as otherwise provided in this section and §§1.47–2 through 1.47–6, the period beginning with the date on which the property was placed in service by the taxpayer and ending with the date of such disposition or cessation. See paragraph (c) of this section.

(iii) In determining the recomputed qualified investment with respect to property which ceases to be section 38 property with respect to the taxpayer after August 15, 1971, or which becomes public utility property after such date, such property shall be treated as if it were property described in section 50 at the time it was placed in service (whether or not it was property described in section 50 at such time). Thus, if property was placed in service on October 15, 1968, and was assigned an estimated useful life of 4 years, there would be no increase in tax under section 47 if the property were disposed of at any time after October 14, 1971, that is, 3 years or more after the property was placed in service.

(b) *Increase in income tax and reduction of investment credit carryover*—(1) *Increase in tax.* Except as provided in subparagraph (2) of this paragraph, any increase in income tax under this section shall be treated as income tax imposed on the taxpayer by chapter 1 of the Code for the recapture year notwithstanding that without regard to such increase the taxpayer has no income tax liability, has a net operating loss for such taxable year, or no income tax return was otherwise required for such taxable year.

(2) *Special rule.* Any increase in income tax under this section shall not be treated as income tax imposed on the taxpayer by chapter 1 of the Code for purposes of determining the amount of the credits allowable to such taxpayer under—

(i) Section 33 (relating to taxes of foreign countries and possessions of United States),

(ii) Section 34 (relating to dividends received by individuals before January 1, 1965),

(iii) Section 35 (relating to partially tax-exempt interest received by individuals),

(iv) Section 37 (relating to retirement income), and

(v) Section 38 (relating to investment in certain depreciable property).

(3) *Reduction in credit allowed as a result of a net operating loss carryback.* (i) If a net operating loss carryback from the recapture year or from any taxable year subsequent to the recapture year reduces the amount allowed as a credit

under section 38 for any taxable year up to and including the recapture year, then there shall be a new recapture determination under paragraph (a) of this section for each recapture year affected, taking into account the reduced amount of credit allowed after application of the net operating loss carryback.

(ii) Subdivision (i) of this subparagraph may be illustrated by the following examples:

Example 1. (*a*) X Corporation, which makes its return on the basis of a calendar year, acquired and placed in service on January 1, 1962, an item of section 38 property with a basis of $10,000 and an estimated useful life of 8 years. The amount of qualified investment with respect to such asset was $10,000. For the taxable year 1962, X Corporation's credit earned of $700 (7 percent of $10,000) was allowed under section 38 as a credit against its liability for tax of $700. In 1963 and 1964 X Corporation had no liability for tax and placed in service no section 38 property. On January 3, 1963, such item of section 38 property was sold to Y Corporation. Since the actual useful life of such item was only 1 year, there was a recapture determination under paragraph (a) of this section. The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1963 was increased by the $700 decrease in its credit earned for the taxable year 1962 (that is, the $700 original credit earned minus zero recomputed credit earned).

(*b*) For the taxable year 1965, X Corporation has a net operating loss which is carried back to the taxable year 1962 and reduces its liability for tax, as defined in paragraph (c) of § 1.46–1, for such taxable year to $200. As a result of such net operating loss carryback, X Corporation's credit allowed under section 38 for the taxable year 1962 is limited to $200 and the excess of $500 ($700 credit earned minus $200 limitation based on amount of tax) is an investment credit carryover to the taxable year 1963.

(*c*) For 1965, there is a recapture determination under subdivision (i) of this subparagraph for the 1963 recapture year. The $700 increase in the income tax imposed on X Corporation for the taxable year 1963 is redetermined to be $200 (that is, the $200 credit allowed after taking into account the 1965 net operating loss minus zero credit which would have been allowed taking into account the 1963 recapture determination). In addition, X Corporation's $500 investment credit carryover to the taxable year 1963 is reduced by $500 ($700 minus $200) to zero and X Corporation is entitled to a $500 refund of the tax paid as a result of the 1963 determination.

Example 2. (*a*) X Corporation, which makes its returns on the basis of a calendar year, acquired and placed in service on January 1, 1962, an item of section 38 property with a basis of $10,000 and an estimated useful life of 8 years. The amount of qualified investment with respect to such asset was $10,000. For the taxable year 1962, X Corporation's credit earned of $700 (7 percent of $10,000) was allowed under section 38 as a credit against its liability for tax of $700. In 1963 and in 1964 X Corporation had no liability for tax and placed in service no section 38 property. On January 3, 1965, such item of section 38 property is sold to Y Corporation. For the taxable year 1965, X Corporation has a net operating loss which is carried back to the taxable year 1962 and reduces its liability for tax, as defined in paragraph (c) of § 1.46–1, for such taxable year to $100.

(*b*) As a result of such net operating loss carryback, X Corporation's credit allowed under section 38 for the taxable year 1962 is limited to $100 and the excess of $600 ($700 credit earned minus $100 limitation based on amount of tax) is an investment credit carryover to the taxable year 1963.

(*c*) Since the actual useful life of the item of section 38 property sold to Y Corporation was only 3 years, there is a recapture determination under paragraph (a) of this section. X Corporation's $600 investment credit carryover to 1963 is reduced by $600 to zero. The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1965 is increased by the $100 reduction in credit allowed by section 38 for 1962.

(4) *Statement of recomputation.* The taxpayer shall attach to his income tax return for the recapture year a separate statement showing in detail the computation of the increase in income tax imposed on such taxpayer by chapter 1 of the Code and the reduction in any investment credit carryovers.

(c) *Date placed in service and date of disposition or cessation*—(1) *General rule.* For purposes of this section and §§ 1.47–2 through 1.47–6, in determining the actual useful life of section 38 property—

(i) Such property shall be treated as placed in service on the first day of the month in which such property is placed in service. The month in which property is placed in service shall be determined under the principles of paragraph (d) of § 1.46–3.

(ii) If during the taxable year such property ceases to be section 38 property with respect to the taxpayer—

(*a*) As a result of the occurrence of an event on a specific date (for example, a sale, transfer, retirement or other disposition), such cessation shall be treated as having occurred on the actual date of such event.

(*b*) For any reason other than the occurrence of an event on a specific date (for example, because such property is used predominantly in connection with the furnishing of lodging during such taxable year), such cessation shall be treated as having occurred on the first day of such taxable year.

(2) *Special rule.* Notwithstanding subparagraph (1) of this paragraph, if a taxpayer uses an averaging convention (see §1.167(a)(10)) in computing depreciation with respect to section 38 property, then, for purposes of this section and §§1.47–2 through 1.47–6, he may use the assumed dates of additions and retirements in determining the actual useful life of such property provided such assumed dates are used consistently for purposes of subpart B of part IV of subchapter A of chapter 1 of the Code with respect to all section 38 property for which such convention is used for purposes of depreciation. This subparagraph shall not apply in any case where from all the facts and circumstances it appears that the use of such assumed dates results in a substantial distortion of the investment credit allowed by section 38. Thus, for example, if the taxpayer computes depreciation under a convention under which the average of the beginning and ending balances of the asset account for the taxable year are taken into account, he may use July 1 as the assumed date of all additions and retirements to such account. Similarly, if the taxpayer computes depreciation under a convention under which the average of the beginning and ending balances of the asset account for each month is taken into account, he may use the date determined by reference to the weighted average of the monthly averages as the assumed date of all additions and retirements to such account.

(3) *Example.* This paragraph may be illustrated by the following example:

Example. Assume that section 38 property is placed in service (within the meaning of paragraph (d) of §1.46–3) on December 1, 1965 (thus, the credit is treated as being earned in 1965) but under the taxpayer's depreciation practice the period for depreciation with respect to such property begins on January 1, 1966, and that the property is actually retired on December 2, 1970. Under the general rule of subparagraph (1) of this paragraph, the property is treated as placed in service on December 1, 1965, and as ceasing to be section 38 property with respect to the taxpayer on December 2, 1970, even though under the taxpayer's depreciation practice the period for depreciation with respect to such property begins on January 1, 1966, and terminates on January 1, 1971. However, under the special rule of subparagraph (2) of this paragraph the taxpayer may determine the actual useful life of the property by reference to the assumed dates of January 1, 1966, and January 1, 1971.

(d) *Examples.* Paragraphs (a) through (c) of this section may be illustrated by the following examples:

Example 1. (i) X Corporation, which makes its returns on the basis of the calendar year, acquired and placed in service on January 1, 1962, three items of section 38 property each with a basis of $12,000 and an estimated useful life of 15 years. The amount of qualified investment with respect to each such asset was $12,000. For the taxable year 1962, X Corporation's credit earned of $2,520 was allowed under section 38 as a credit against its liability for tax of $4,000. On December 2, 1965, one of the items of section 38 property is sold to Y Corporation.

(ii) The actual useful life of the item of property which is sold on December 2, 1965, is three years and eleven months. The recomputed qualified investment with respect to such item of property is zero ($12,000 basis multiplied by zero applicable percentage) and X Corporation's recomputed credit earned for the taxable year 1962 is $1,680 (7 percent of $24,000). The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1965 is increased by the $840 decrease in its credit earned for the taxable year 1962 (that is, $2,520 original credit earned minus $1,680 recomputed credit earned).

Example 2. (i) The facts are the same as in example 1 and in addition on December 2, 1966, a second item of section 38 property placed in service in the taxable year 1962 is sold to Y Corporation.

(ii) The actual useful life of the item of property which is sold on December 2, 1966, is four years and eleven months. The recomputed qualified investment with respect to such item of property is $4,000 ($12,000 basis multiplied by 33⅓ percent applicable percentage) and X Corporation's recomputed credit earned for the taxable year 1962 is $1,120 (7 percent of $16,000). The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1966 is increased by $560 (that is, $1,400 ($2,520 original credit earned minus $1,120 recomputed credit earned) reduced by the $840 increase in tax for 1965).

Example 3. (i) The facts are the same as in example 1 except that for the taxable year 1962 X Corporation's liability for tax under section 46(a)(3) is only $1,520. Therefore, for such taxable year X Corporation's credit allowed under section 38 is limited to $1,520 and the excess of $1,000 ($2,520 credit earned minus $1,520 limitation based on amount of tax) is an unused credit. Of such $1,000 unused credit, $100 is allowed as a credit under section 38 for the taxable year 1963, $100 is allowed for 1964, and $800 is carried to the taxable year 1965.

(ii) The actual useful life of the item of property which is sold on December 2, 1965, is three years and eleven months. The recomputed qualified investment with respect to such item of property is zero ($12,000 basis multiplied by zero applicable percentage) and X Corporation's recomputed credit earned for the taxable year 1962 is $1,680 (7 percent of $24,000). If such $1,680 recomputed credit earned had been taken into account in place of the $2,520 original credit earned, X's credit allowed for 1962 would have been $1,520, and of the $160 unused credit from 1962 $100 would have been allowed as a credit under section 38 for 1963, and $60 would have been allowed for 1964. X Corporation's $800 investment credit carryover to the taxable year 1965 is reduced by $800 to zero. The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1965 is increased by $40 (that is, the aggregate reduction in the credits allowed by section 38 for 1962, 1963, and 1964).

Example 4. (i) X Corporation, which makes its returns on the basis of the calendar year, acquired and placed in service on November 1, 1962, an item of section 38 property with a basis of $12,000 and an estimated useful life of 10 years. The amount of qualified investment with respect to such property was $12,000. For the taxable year 1962, X Corporation's credit earned of $840 was allowed under section 38 as a credit against its liability for tax of $840. For each of the taxable years 1963 and 1964 X Corporation's liability for tax was zero and its credit earned was $400; therefore, for each of such years its unused credit was $400. For the taxable year 1965 its liability for tax was $200 and its credit earned was zero; therefore, $200 of the $400 unused credit from 1963 was allowed as credit for 1965 and $600 ($200 from 1963 and $400 from 1964) is an investment credit carryover to 1966. On February 2, 1966, such item of section 38 property is sold to Y Corporation.

(ii) The actual useful life of such item of property is three years and three months. The recomputed qualified investment with respect to such property is zero ($12,000 basis multipled by zero) and X Corporation's recomputed credit earned for the taxable year 1962 is zero. If such zero recomputed credit earned had been taken into account in place of the $840 original credit earned, the entire $400 unused credit from 1963 (including the $200 portion which was originally allowed as a credit for 1965) and the $400 unused credit from 1964 would have been allowed as investment credit carrybacks against X Corporation's liability for tax of $840 for 1962. (See §1.46–2 for rules relating to the carryback of unused credits.)

(iii) Therefore, the $600 carryover from 1963 and 1964 to 1966 is eliminated and the income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1966 is increased by the $240 aggregate reduction in the credits allowed by section 38 for the taxable years 1962 and 1965 (that is, $1,040 credit allowed minus $800 which would have been allowed).

Example 5. (i) X Corporation, which makes its returns on the basis of the calendar year, acquired and placed in service on November 1, 1962, an item of section 38 property with a basis of $10,000 and an estimated useful life of 8 years. The amount of qualified investment with respect to such asset was $10,000. For the taxable year 1962, X Corporation's credit earned of $700 was allowed as a credit against its liability for tax. For each of the taxable years 1963, 1964, and 1965 X had no taxable income. On July 3, 1966, the item of section 38 property is sold to Y Corporation. For the taxable year 1966 X Corporation has a net operating loss of $3,000.

(ii) The actual useful life of the item of property is three years and eight months. The recomputed qualified investment with respect to such item of property is zero and X Corporation's recomputed credit earned for the taxable year 1962 is zero. Notwithstanding the $3,000 net operating loss for the taxable year 1966, the income tax imposed by chapter 1 of the Code on X Corporation for such year is $700 (that is, the decrease in its credit earned for the taxable year 1962).

(e) *Identification of property*—(1) *General rule*—(i) *Record requirements.* In general, the taxpayer must maintain records from which he can establish, with respect to each item of section 38 property, the following facts:

(*a*) The date the property is disposed of or otherwise ceases to be section 38 property,

(*b*) The estimated useful life which was assigned to the property under paragraph (e) of §1.46–3,

(*c*) The month and the taxable year in which the property was placed in service, and (*d*) The basis (or cost), actually or reasonably determined, of the property.

(ii) *Recapture determination.* For purposes of determining whether section 38 property is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of its estimated useful life, and for purposes of determining recomputed qualified investment, the taxpayer must establish from his records the facts required by subdivision (i) of this subparagraph.

(iii) *Examples.* If the taxpayer fails to maintain records from which he can establish the facts required by subdivision (i) of this subparagraph, then this section shall be applied to the taxpayer in the manner indicated in the following examples:

Example 1. Corporation X, organized on January 1, 1964, files its income tax return on the basis of a calendar year. During the years 1964 and 1965, X places in service several items of machinery to which it assigns estimated useful lives of 8 years. X places the items of machinery in a composite account for purposes of computing depreciation. When X's 1966 return is being audited, X is unable to establish whether the items placed in service in 1964 and 1965 were still on hand at the end of 1966. Therefore, for purposes of paragraph (a) of this section, X is treated as having disposed of, in 1966, all of the items of machinery placed in service in 1964 and 1965.

Example 2. Corporation Y, organized on January 1, 1960, files its income tax return on the basis of a calendar year. During each of the years 1960 through 1965, Y places in service four items of machinery to each of which it assigns an estimated useful life of 8 years for depreciation purposes (and for purposes of computing qualified investment for relevant years). Y places the items of machinery in a composite account for purposes of computing depreciation (and for purposes of computing qualified investment for relevant years). When Y's 1965 return is being audited, Y can establish that it retired during 1965 only six items of this machinery. However, Y cannot establish the date on which these six items were placed in service, nor can Y establish that the items placed in service in 1963 or 1964 are still on hand as of the end of 1965. No previous recapture has taken place with respect to any of the items placed in service in 1963 or 1964. Assuming that paragraph (e) (2) and (3) of this section is not applicable, Y is treated, for purposes of paragraph (a) of this section, as having disposed of, in 1965, the four items placed in service in 1964, the most recent year before 1965 in which such property was placed in service, and two items from 1963, the next most recent year.

Example 3. The facts are the same as in example 2 except that when Y's 1966 return is being audited, Y can establish from its records that all four items placed in service in 1965 are still on hand and that only three items were retired in 1966. For purposes of paragraph (a) of this section, Y is treated as having disposed of, in 1966, the two remaining items of machinery placed in service in 1963, and one of the items placed in service in 1962.

(2) *Treatment of ''mass assets''.* (i) If, in the case of mass assets (as defined in subparagraph (4) of this paragraph), it is impracticable for the taxpayer to maintain records from which he can establish with respect to each item of section 38 property the facts required by subparagraph (1) of this paragraph, and if he adopts other reasonable recordkeeping practices, consonant with good accounting and engineering practices, and consistent with his prior recordkeeping practices, then he may substitute data from an appropriate mortality dispersion table. An appropriate mortality dispersion table must be based on an acceptable sampling of the taxpayer's actual experience or other acceptable statistical or engineering techniques. In lieu of such mortality dispersion table, the taxpayer may use a standard mortality dispersion table prescribed by the Commissioner. If the taxpayer uses such standard mortality dispersion table for any taxable year, it must be used for all subsequent taxable years unless the taxpayer obtains the consent of the Commissioner to change. If mass assets are placed in a multiple asset account and if the depreciation rate for such account is based on the maximum expected life of the longest lived asset in such account, in applying a mortality dispersion table (including a standard mortality dispersion table) the average expected useful life of the mass assets in such account must be used.

(ii) Subdivision (i) of this subparagraph shall not apply with respect to assets placed in service in a taxable year ending on or after June 30, 1967, and beginning before January 1, 1971, or with respect to assets placed in service for a taxable year beginning after

December 31, 1970, for which the taxpayer has not made the election provided by section 167(m), unless the estimated useful lives which were assigned to such assets for purposes of determining qualified investment—

(*a*) Were separate lives based on the estimated range of years taken into account in establishing the average useful life of assets similar in kind under paragraph (e)(3)(ii)(*b*) of §1.46–3, and

(*b*) Were determined by use of a mortality dispersion table (including a standard mortality dispersion table).

(iii) Any standard mortality dispersion table prescribed by the Commissioner shall be based on average useful life categories and with respect to each category shall contain five columns, the first four of which shall state the percentage of property assumed to have a useful life of—

Column (1): Less than 4 years,
Column (2): 4 years or more but less than 6 years,
Column (3): 6 years or more but less than 8 years, and
Column (4): 8 years or more.

The fifth column shall show the total qualified investment as a percentage and shall be used in connection with the determination to be made under §1.46–3(e)(3)(iii). In the case of a table which is to apply to property which is described in section 50 or to property which is treated as property described in section 50 under paragraph (a)(2)(iii) of this section, this subdivision shall be applied by substituting ''3 years'' for ''4 years'', ''5 years'' for ''6 years'', and ''7 years'' for ''8 years''.

(iv) Whenever the standard mortality dispersion table is used for a taxable year under subdivision (i) of this subparagraph (whether or not such table was used in determining qualified investment), the percentage of property shown in column (1) of the table shall (for purposes of section 47, this section, and §§1.47–2 through 1.47–6) be deemed to have been disposed of on the day before the expiration of the 4-year period beginning on the date on which it was considered as placed in service under §1.47–1(c); the percentage of property shown in column (2) of the table shall be deemed to have been disposed of on the day before the expiration of the 6-year period beginning on the date on which it was so considered as placed in service; and the percentage of property shown in column (3) shall be deemed to have been disposed of on the day before the expiration of the 8-year period beginning on the date on which it was so considered as placed in service. In applying this subdivision for purposes of recomputing qualified investment, the proper average useful life category shall be used whether or not such category was used in determining qualified investment. In the case of property which is described in section 50 or property which is treated as property described in section 50 under paragraph (a)(2)(iii) of this section (other than property the qualified investment with respect to which was determined by use of the standard or an appropriate mortality dispersion table), this subdivision shall be applied by substituting ''3-year period'' for ''4-year period'', ''5-year period'' for ''6-year period'', and ''7-year period'' for ''8-year period''.

(v) In lieu of using subdivision (iv) of this subparagraph for purposes of recomputing qualified investment, a taxpayer may, for the first recapture year (as defined in paragraph (a)(1)(ii)(*b*) of this section) to which such subdivision (iv) would otherwise apply with respect to any mass asset account, recompute qualified investment on the basis of the difference between (*a*) the proper total qualified investment based on the percentage shown in column (5) of the table, and (*b*) the total qualified investment actually claimed by the taxpayer for the year in which the property was placed in service.

Example. Assume that the taxpayer places in service during 1963 mass assets costing him $100,000, that he places these assets in a multiple asset account for which he properly claims a useful life of 6 years and a qualified investment of $66,667 (⅔ × $100,000), and that he is allowed an investment credit of $4,667.67. When the taxpayer's 1967 return is being audited he is unable to establish that any of the mass assets placed in service in 1963 were still on hand at the end of 1967.

The taxpayer elects to use the standard mortality dispersion table prescribed by the Commissioner to determine the amount of recapture with respect to these mass assets. Assume that the table prescribed by the Commissioner shows with respect to mass assets with an average useful life of 6 years the following:

Percent of property assumed to have a useful life of—				Total qualified investment (percent) (5)
Less than 4 years (1)	4 years or more, but less than 6 years (2)	6 years or more, but less than 8 years (3)	8 years or more (4)	
15.87	34.13	34.13	15.87	50.00

(*a*) Under these circumstances 15.87 percent of the mass assets placed in service in 1963 are deemed to have been disposed of during 1967. With respect to these assets, the amount of qualified investment for 1963 was $10,580 ($15,870 × ⅔) and the amount of credit earned was $740.60 (7 percent of $10,580), whereas the recomputed qualified investment is zero and the recomputed credit earned is zero. Thus, the tax imposed by chapter 1 of the Code for 1967 is increased by $740.60.

(*b*) No recapture determination is required for 1968 since no assets are deemed to have been disposed of in that year. During 1969, 34.13 percent of the mass assets placed in service in 1963 are deemed to have been disposed of. With respect to these assets, the amount of qualified investment for 1963 was $22,753.34 ($34,130 × ⅔) and the amount of credit earned was $1,592.73 (7 percent of $22,753.34), whereas the recomputed qualified investment is $11,376.67 ($34,130 × ⅓) and the recomputed credit earned is $796.37 (7 percent of $11,376.67). Thus, the tax imposed by chapter 1 of the Code for 1969 is increased by $796.36 ($1,592.73 minus $796.37).

(*c*) If the taxpayer chooses to recompute qualified investment by using the method provided in subdivision (v) of this subparagraph, the increase in tax for 1967 (the first recapture year) would be $1,167.67, *i.e.*, the original credit earned, $4,667.67, minus the recomputed credit earned, $3,500 (50 percent, the percentage shown in column (5), of $100,000 multiplied by 7 percent). As long as the same average useful life category reflects the taxpayer's experience for subsequent years, no recapture determination will be required for any future year, except as provided by subparagraph (3)(iv) of this paragraph.

(vi) Subdivision (i) of this subparagraph shall not apply with respect to section 38 property to which an election under section 167(m) applies unless the taxpayer assigns actual retirements of such section 38 property for all taxable years to the same vintage account for purposes of section 47 and for purposes of computing the allowance for depreciation under section 167. The assignment of actual retirements of section 38 property for a taxable year to particular vintage accounts may be made on the basis of an appropriate mortality dispersion table (based on an acceptable sampling of the taxpayer's actual experience or other statistical or engineering techniques) or on the basis of a standard mortality dispersion table prescribed by the Commissioner. If the taxpayer assigns actual retirements for any taxable year to particular vintage accounts on the basis of such standard mortality dispersion table, actual retirements for all subsequent taxable years must be assigned to particular vintage accounts on the basis of such table. Actual retirements of section 38 property for a taxable year shall be assigned to particular vintage accounts by—

(*a*) Determining the expected retirements for such taxable year from each vintage account containing such section 38 property, and

(*b*) Ratably allocating such actual retirements to each vintage account containing such section 38 property.

However, the unadjusted basis of retired assets assigned to any particular vintage account shall not exceed the unadjusted basis of the property contained in such account.

(3) *Special rules.* (i) Taxpayers who properly determine estimated useful lives under §1.46–3(e)(3) (ii)(*b*) or (iii) may treat such assets as having been disposed of or having ceased to be section 38 assets in the order of the estimated useful lives that were assigned to such assets. Thus, the asset that is first disposed of or first ceases to be section 38 property may be treated as the asset to which there was assigned the shortest estimated useful life; the next asset disposed of or ceasing to be section 38 property may be treated as the asset to which there was assigned the second shortest life, etc.

(ii) In the case of taxpayers who use the rule of subdivision (i) of this subparagraph with respect to mass assets for which the estimated useful life was determined under §1.46–3(e)(3)(iii), if the dispersion shown by the mortality dispersion table effective for a taxable year subsequent to the credit year is the same as the dispersion shown by the mortality table that was effective for the credit year (for example, if the same average useful life on the standard mortality dispersion table reflects the taxpayer's experience for both such years), no recapture determination is required for such subsequent taxable year.

(iii) Notwithstanding subdivision (i) of this subparagraph, taxpayers who, for purposes of determining qualified investment, do not use a mortality dispersion table with respect to certain section 38 assets similar in kind but who consistently assign under paragraph (e)(3)(ii)(*b*) of §1.46–3 to such assets separate lives based on the estimated range of years taken into consideration in establishing the average useful life of such assets, may select the order in which such assets shall be considered as having been disposed of, regardless of the taxable years in which such assets were placed in service. If a taxpayer uses the method provided in this subdivision to determine that any asset is considered as having been disposed of, then, in addition to complying with the record requirements of subparagraph (1)(i) of this paragraph, such taxpayer must maintain records from which he can establish to the satisfaction of the district director that such asset has not previously been considered as having been disposed of. In addition, if, for any taxable year, a taxpayer uses the method provided in this subdivision for any asset, he must use for such year and for each subsequent taxable year (unless he obtains the district director's consent to change) with respect to all assets similar in kind to such asset—

(*a*) The method of determining estimated useful lives described in paragraph (e)(3)(ii)(*b*) of §1.46–3, and

(*b*) The method he has selected under this subdivision for determining the order in which such assets are considered as having been disposed of.

A request by a taxpayer to obtain the district director's consent to change a system or method described in this subdivision with respect to assets similar in kind must be submitted to the district director on or before the last day of the taxable year with respect to which the change is sought.

(iv) Notwithstanding subdivisions (i), (ii), and (iii) of this subparagraph, there shall be taken into account separately any abnormal retirement of section 38 property of substantial value for which the estimated useful life was determined under §1.46–3(e)(3) (ii)(*b*) or (iii). For definition of abnormal retirement, see paragraph (b) of §1.167(a)–8.

(4) [Reserved]

(5) *Example*. This paragraph may be illustrated by the following example:

Example. (i) Taxpayer A uses numerous small returnable containers in his business. It is impracticable for A to keep individual detailed records with respect to such containers which are mass assets. In 1965, A places in service 10 million containers purchased for $1 million, and reasonably determines that each of such containers has a basis of 10 cents. A places such containers in a multiple asset account to which is assigned a 5-year average useful life for purposes of computing depreciation. A has conducted an appropriate mortality study which shows that the containers have the following estimated useful lives:

Percent of assets	Useful life (years)
10	3
20	6
40	5
20	6
10	7

A assigns separate lives to such assets based on the estimated range of years taken into account in establishing the average useful life of such containers. The qualified investment with respect to such containers is $400,000 computed as follows:

Useful life	Basis	Applicable percentage	Qualified investment
4	$200,000	33⅓	$66,666
5	400,000	33⅓	133,334
6	200,000	66⅔	133,334
7	100,000	66⅔	66,666
			400,000

A's credit earned for 1965 of $28,000 (7 percent times $400,000) is allowed as a credit under section 38 against A's liability for tax of $2 million. (For purposes of this example the computations of investment credit and recapture with respect to containers placed in service in years other than 1965 are omitted.) The mortality studies effective for 1966 and 1967 show that none of the containers placed in service in 1965 was retired.

(ii) A's mortality study effective with respect to 1968 shows that the containers are being retired as follows:

Percent of assets	Useful life (years)
30	3
20	4
30	5
10	6
10	7

Thus, the 1968 study shows that 30 percent of the 10 million containers placed in service in 1965 were retired in 1968. Under the rule of subparagraph (3)(i) of this paragraph, the 3 million containers are treated as consisting of the 1 million containers to which was assigned a 3-year useful life and the 2 million containers to which was assigned a 4-year useful life. Taking into account only the fact that 30 percent of the containers placed in service in 1965 had an actual life of less than 4 years, A's recomputed qualified investment for 1965 is $333,333 and his recomputed credit earned is $23,333. A's income tax for 1968 is increased by $4,667 ($28,000 original credit earned minus $23,333 recomputed credit earned).

(iii) The mortality study effective for 1969 shows the same results as the mortality study effective for 1968. Thus, it shows that 2 million containers were retired in 1969 (an actual life of 4 years). Under the rule of subparagraph (3)(i) of this paragraph such 2 million containers are treated as having been among 4 million containers to which were assigned a 5-year useful life. Therefore, no recapture determination is required for 1969.

(iv) The mortality study effective for 1970 shows the same results as the mortality study effective for 1968. Thus, it shows that 3 million containers were retired in 1970 (an actual life of 5 years). Under the rule of subparagraph (3)(i) of this paragraph, the 3 million are treated as having been assigned useful lives as follows: 2 million as having been assigned a useful life of 5 years, and 1 million as having been assigned a useful life of 6 years. Taking into account only the fact that 10 percent of the containers placed in service in 1965 had an actual life of 5 years rather than the 6 years estimated useful life assigned to them, A's recomputed qualified investment is $300,000 and A's credit earned for 1965 is $21,000. Thus, taking into account the 1968 recapture determination A's income tax for 1970 is increased by $2,333.

(f) *Public utility property*—(1) *Recomputed qualified investment.* In recomputing qualified investment with respect to section 38 property which becomes public utility property (as defined in paragraph (g) of §1.46–3)—

(i) If such property becomes public utility property less than 3 years from the date on which it was placed in service, then such property shall be treated as public utility property for its entire useful life.

(ii) If such property becomes public utility property 3 years or more but less than 5 years from the date on which it was placed in service, then such property shall be treated as section 38 property which is not public utility property for the first 3 years of its estimated useful life and as public utility property for the remaining period of its estimated useful life.

(iii) If such property becomes public utility property 5 years or more but less than 7 years from the date on which it was placed in service, then such property shall be treated as section 38 property which is not public utility property for the first 5 years of its estimated useful life and as public utility property for the remaining period of its estimated useful life.

If property becomes public utility property before August 16, 1971, this subparagraph shall be applied by substituting ''4 years'' for ''3 years'', ''6 years'' for ''5 years'', and ''8 years'' for ''7 years''.

(2) *Examples.* Subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. (i) X Corporation, which makes its returns on the basis of the calendar year, acquired and placed in service on January 1, 1969, an item of section 38 property with a basis of $12,000 and an estimated useful life of 8 years. The amount of qualified investment with respect to such property was $12,000. For the taxable year 1969, X Corporation's credit earned was $840 (7 percent of $12,000) and for such taxable year X Corporation was allowed under section 38 a credit of $840 against its liability for tax. During the taxable year 1972 such property becomes public utility property (as defined in paragraph (g) of §1.46–3) with respect to X Corporation.

(ii) Such item of section 38 property is treated as section 38 property which is not public utility property for the first 3 years of its 8-year estimated useful life and is treated as public utility property for the remaining 5 years. The recomputed qualified investment with respect to such item of section 38 property is $7,428, computed as follows:

$12,000 basis × 33⅓ percent applicable percentage	$4,000
$12,000 basis × 5/7 × 66⅔ percent applicable percentage	3,428
Total recomputed qualified investment	7,428

X Corporation's recomputed credit earned for the taxable year 1969 is $520 (7 percent of

$7,428). The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1972 is increased by the $320 decrease in its credit earned for the taxable year 1969 (that is, $840 original credit earned minus $520 recomputed credit earned).

Example 2. (i) The facts are the same as in example 1 and in addition the item of section 38 property which became public utility property in 1972 is sold to Y Corporation on January 2, 1975.

(ii) The actual useful life of such item of property is 6 years. For the first 3 years of its 8-year estimated useful life such item is treated as section 38 property which is not public utility property and for the remaining 3 years is treated as public utility property. The recomputed qualified investment with respect to such item of property is $5,714, computed as follows:

$12,000 basis × 33⅓ percent applicable percentage	$4,000
$12,000 basis × 3⁄7 × 33⅓ percent applicable percentage	1,714
Total recomputed qualified investment	5,714

X Corporation's recomputed credit earned for the taxable year 1969 is $400 (7 percent of $5,714). The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1975 is increased by $120 (that is, $440 ($840 original credit earned minus $400 recomputed credit earned) minus $320 increase in tax for 1969).

(g) *Special rules for progress expenditure property.* Under section 47(a)(3), a recapture determination is required if property ceases to be progress expenditure property (as defined in §1.46–5(d)). Property ceases to be progress expenditure property if it is sold or otherwise disposed of before it is placed in service. For example, cancellation of the contract for progress expenditure property or abandonment of the project by the taxpayer will be considered a ''disposition'' within the meaning of §1.47–2. A cessation occurs if progress expenditure property ceases to be property that will be section 38 property with a useful life of 7 years or more when placed in service. In general, a sale and leaseback is treated as a cessation. However, see paragraph (g)(2) of §1.47–3 for special rules for certain sale and leaseback transactions. Recapture determinations for progress expenditure property are to be made in a way similar to that provided under §§1.47–1 through 1.47–6. Reduction of qualified investment must begin with the most recent credit year (*i.e.*, the most recent taxable year the property is taken into account in computing qualified investment under §1.46–3 or 1.46–5).

(h) *Special rules for energy property*—(1) *In general.* A recapture determination is required for the investment credit attributable to the energy percentage (energy credit) if property is (i) disposed of or (ii) otherwise ceases to be energy property (as defined in section 48(l)) with regard to the taxpayer before the close of the estimated useful life (as determined under paragraph (a)(2)(i) of this section) which was taken into account in computing qualified investment.

(2) *Dispositions.* The term ''disposition'' is described in §1.47–2(a)(1). A transfer of energy property that is a ''disposition'' requiring a recapture determination for the investment credit attributable to the regular percentage (regular credit) and the ESOP percentage (ESOP credit) will also be a ''disposition'' requiring a recapture determination for the energy credit.

(3) *Cessation.* (i) The term ''cessation'' is described in §1.47–2(a)(2). For energy property, a cessation occurs during a taxable year if, by reason of a change in use or otherwise, the property would not have qualified for an energy credit if placed in service during that year. A change in use will not require a recapture determination for the regular or ESOP credit unless, by reason of the change, the property would not have qualified for the regular or ESOP credit if placed in service during that year.

(ii) A qualified intercity bus described in §1.48–9(q) must meet the predominant use test (of §1.48–9(q)(7)) for the remainder of the taxable year from the date it is placed in service and for each taxable year thereafter. A cessation occurs in any taxable year in which the bus is no longer a qualifying bus under §1.48–9(q)(6). A qualified intercity bus does not cease to be energy property for a taxable year subsequent to the one in which it was placed in service by reason of a decrease in operating capacity (see §1.48–9(q)(9)) for that year compared to any prior taxable year.

(4) *Recordkeeping requirement.* For recordkeeping requirements with respect to dispositions or cessations, the rules of paragraph (e)(1) of this section

apply. For example, the taxpayer must maintain records for each recycling facility indicating the percentage of virgin materials used each year. See, § 1.48–9(g)(5)(ii).

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

Example 1. (a) In 1980, corporation X, a calendar year taxpayer, acquires and places in service a computer that will perform solely energy conserving functions in connection with an existing industrial process. Assume the computer has a 10 year useful life and qualifies for both the regular and energy credits. In 1981, a change is made in the industrial process (within the meaning of § 1.48–9(l)(2)). However, for 1981 the computer continues to perform solely energy conserving functions. In 1982, the computer ceases to perform energy conserving functions and begins to perform a production related function.

(b) For 1981, a recapture determination is not required. For 1982, the entire energy credit must be recaptured, although none of the regular credit is recaptured. If in 1989 the computer first ceased to perform an energy conserving function, no part of the energy credit would be recaptured.

Example 2. Assume the same facts and conclusion as in example 1. Assume further that X sells the computer in 1985. A recapture determination is required for the regular credit.

Example 3. In 1981, corporation Y, a calendar year taxpayer, acquires and places in service recycling equipment. Assume the equipment has a 7-year useful life and qualifies for both the regular credit and energy credit. During the course of 1982, more than 10 percent of the material recycled is virgin material. The energy credit is recaptured in its entirety, although none of the regular credit is recaptured. See § 1.48–9(g)(5)(B)(ii).

Example 4. In 1980, corporation Z, a calendar year taxpayer, acquires and places in service a boiler the primary fuel for which is an alternate substance. The boiler has a 7-year useful life. Assume the boiler is a structural component of a building within the meaning of § 1.48–1(e)(2). Assume further that the boiler is not a part of a qualified rehabilitated building (as defined in section 48(g)(1)) or a single purpose agricultural or horticultural structure (as defined in section 48(p)). Z is allowed only an energy credit since the boiler is a structural component of a building. In 1984, Z modifies the boiler to use oil as the primary fuel. A recapture determination is required for the energy credit. See § 1.48–9(c)(3).

(i)–(l) [Reserved]

(m) *Commuter highway vehicles*—(1) *Recomputed qualified investment.* (i) If a qualifying commuter highway vehicle (as defined in § 1.46–11(a) undergoes a change in use but does not cease to be section 38 property, qualified investment for that vehicle is recomputed as if the vehicle was section 38 property which is not a qualifying commuter highway vehicle for its entire useful life.

(ii) The following example illustrates this paragraph (m)(1).

Example. X Corporation, a calendar year taxpayer, acquired and placed in service on January 1, 1982, a qualifying commuter highway vehicle with a basis of $10,000 and which qualified as three year recovery property under section 168(c)(2)(A)(i). The amount of qualified investment for the vehicle under section 46(c) (1) and (6) is $10,000. For the taxable year 1982, X Corporation's credit earned was $1,000 (10 percent of $10,000) and X Corporation was allowed under section 38 a $1,000 credit against its 1982 tax liability. During the taxable year 1984, the vehicle undergoes a change in use but does not cease to be section 38 property. The vehicle is treated as section 38 property which is not a qualifying commuter highway vehicle for its entire useful life. The recomputed qualified investment for the vehicle is $6,000 (60 percent of $10,000) and X Corporation's recomputed credit earned is $600 (10 percent of $6,000). The income tax imposed by chapter 1 of the Code on X Corporation for 1984 is increased by the $400 decrease in its credit earned for 1982 ($1,000 − $600).

(2) *Change in use*—(i) A qualifying commuter highway vehicle undergoes a change in use if the vehicle does not meet the commuter use requirement (as defined in § 1.46–11(d)) for each computation period.

(ii) Each of the following is a computation period:

(A) The period beginning on the date the vehicle was placed in service and ending on the last day of the taxpayer's taxable year in which the vehicle was placed in service;

(B) Each of the taxpayer's taxable years beginning after the date the vehicle was placed in service and ending before the end of the first 36 months after the vehicle was placed in service; and

(C) The period ending at the end of the first 36 months after the vehicle was placed in service and beginning on the first day of the taxpayer's taxable year in which the end of those first 36 months falls.

(iii) The following example illustrates this paragraph (m)(2).

Example. (*a*) Z Corporation, a calendar year taxpayer, acquired and placed in service a qualifying commuter highway vehicle on January 15, 1979. Z Corporation used the vehicle as set forth in the following table:

Taxable year ending	Total miles	Commuter miles	Ratio
1979	10,000	9,000	.90
1980	10,000	8,000	.80
1981	10,000	8,000	.80
1982 (1–14)	1,000	100	.10

(*b*) The first computation period begins on the date the vehicle is placed in service, in this example 1–15–79, and ends 12–31–79. In that computation period, the ratio of commuter miles to total miles is .90 (9,000 miles ÷ 10,000 miles). Therefore, the vehicle meets the commuter use requirement for that period and has not undergone a change in use. Similar calculations for the computation periods 1–1–80 to 12–31–80 and 1–1–81 to 12–31–81 produce the same result.

(*c*) As of the computation period beginning 1–1–82 and ending 1–14–82, the ratio of commuter use to total mileage is .10 (100 miles ÷ 1,000 miles). Since that ratio is less than .80, the vehicle does not meet the commuter use requirement for the period and the vehicle has undergone a change in use.

(Secs. 38(b) (76 Stat. 963, 26 U.S.C. 38(b)), 48(l)(16) (94 Stat. 264, 26 U.S.C. 48(l)(16)), and 7805 (68A Stat. 917, 26 U.S.C. 7805))

[T.D. 6931, 32 FR 14027, Oct. 10, 1967, as amended by T.D. 7203, 37 FR 17127, Aug. 25, 1972; T.D. 7765, 46 FR 7291, Jan. 23, 1981; T.D. 7982, 49 FR 39541, Oct. 9, 1984; T.D. 8035, 50 FR 29370, July 19, 1985; T.D. 8183, 53 FR 6625, Mar. 2, 1988; T.D. 8474, 58 FR 25557, Apr. 27, 1993]

§ 1.47–2 "Disposition" and "cessation".

(a) *General rule*—(1) *''Disposition''*. For purposes of this section and § 1.47–1 and §§ 1.47–3 through 1.47–6, the term ''disposition'' includes a sale in a sale-and-leaseback transaction, a transfer upon the foreclosure of a security interest and a gift, but such term does not include a mere transfer of title to a creditor upon creation of a security interest. See paragraph (g) of § 1.47–3 for treatment of certain sale-and-leaseback transactions.

(2) *''Cessation''*. (i) A determination of whether section 38 property ceases to be section 38 property with respect to the taxpayer must be made for each taxable year subsequent to the credit year. Thus, in each such taxable year the taxpayer must determine, as if such property were placed in service in such taxable year, whether such property would qualify as section 38 property (within the meaning of § 1.48–1) in the hands of the taxpayer for such taxable year.

(ii) Section 38 property does not cease to be section 38 property with respect to the taxpayer in any taxable year subsequent to the credit year merely because under the taxpayer's depreciation practice no deduction for depreciation with respect to such property is allowable to the taxpayer for the taxable year, provided that the property continues to be used in the taxpayer's trade or business (or in the production of income) and otherwise qualifies as section 38 property with respect to the taxpayer.

(iii) This subparagraph may be illustrated by the following examples:

Example 1. A, an individual who makes his returns on the basis of the calendar year, on January 1, 1962, acquired and placed in service in his trade or business an item of section 38 property with an estimated useful life of eight years. On January 1, 1965, A removes the item of section 38 property from use in his trade or business by converting such item to personal use. Therefore no deduction for depreciation with respect to such item of property is allowable to A for the taxable year 1965. On January 1, 1965, such item of property ceases to be section 38 property with respect to A.

Example 2. On January 1, 1965, A placed in service an item of section 38 property with a basis of $10,000 and an estimated useful life of 4 years. A depreciates such item, which has a salvage value of $2,000 (after taking into account section 167(f)), on the declining balance method at a rate of 50 percent (that is, twice the straight line rate of 25 percent). With respect to such item, A is allowed deductions for depreciation of $5,000 for 1965, $2,500 for 1966, and $500 for 1967. A is not allowed a deduction for depreciation for 1968 although he continues to use such item in his trade or business. Such item does not cease to be section 38 property with respect to A in 1968.

(b) *Leased property*—(1) *In general.* For purposes of paragraph (a) of § 1.47–1, generally the mere leasing of section 38 property by a lessor who took the basis of such property into account in computing his qualified investment for the credit year shall not be considered to be a disposition. However, in a case where a lease is treated as a sale for income tax purposes such transaction is considered to be a disposition. Leased section 38 property ceases to be section 38 property with respect to the lessor if, in any taxable year subsequent to the credit year, such property would not qualify as section 38 property (as defined in §1.48–1) in the hands of the lessor, the lessee, or any sublessee. Thus, if, in a taxable year subsequent to the credit year, a lessee uses the property predominantly outside the United States, such property shall be considered to have ceased to be section 38 property with respect to the lessor.

(2) *Where lessor elects to treat lessee as purchaser.* For purposes of paragraph (a) of §1.47–1, if, under §1.48–4, the lessor of new section 38 property made a valid election to treat the lessee as having purchased such property for purposes of the credit allowed by section 38, the following rules apply in determining whether such property is disposed of, or otherwise ceases to be section 38 property with respect to the lessee:

(i) Generally, a mere disposition by the lessor of property subject to a lease shall not be considered to be a disposition by the lessee.

(ii) If the lessor makes a disposition of property subject to a lease to a person who may not, under §1.48–4, make a valid election to treat the lessee as having purchased such property for purposes of the credit allowed by section 38 (such as a person described in paragraph (a)(5) of §1.48–4), such property shall be considered to have ceased to be section 38 property with respect to the lessee on the date of such disposition.

(iii) If a lease is terminated and the property is transferred by the lessee to the lessor or to any other person, such transfer shall be considered to be a disposition by the lessee.

(iv) If the lessee actually purchases such property in the credit year or in a taxable year subsequent to the credit year, such purchase shall not be considered to be a disposition.

(v) The property ceases to be section 38 property with respect to the lessee if in any taxable year subsequent to the credit year such property would not qualify as section 38 property (as defined in §1.48–1) in the hands of the lessor, the lessee, or any sublessee. Thus, for example, if, in a taxable year subsequent to the credit year, a sublessee uses the property predominantly outside the United States, the property ceases to be section 38 property with respect to the lessee.

(c) *Reduction in basis of section 38 property*—(1) *General rule.* If, in the credit year or in any taxable year subsequent to the credit year, the basis (or cost) of section 38 property is reduced, for example, as a result of a refund of part of the cost of the property, then such section 38 property shall be treated as having ceased to be section 38 property with respect to the taxpayer to the extent of the amount of such reduction in basis (or cost) on the date the refund which results in such reduction in basis (or cost) is received or accrued, except that for purposes of §1.47–1(a) the actual useful life of the property treated as having ceased to be section 38 property shall be considered to be less than 3 years.

(2) *Example.* Subparagraph (1) of this paragraph may be illustrated by the following example:

Example. (i) On January 1, 1962, A, a cash basis taxpayer, acquired from X Cooperative an item of section 38 property with a basis of $100 and an estimated useful life of 10 years which he placed in service on such date. The amount of qualified investment with respect to such asset was $100. For the taxable year 1962 A was allowed under section 38 a credit of $7 against his liability for tax. On June 1, 1963, A receives a $10 patronage dividend from X Cooperative with respect to such asset. Under paragraph (c)(2)(i) of §1.1385–1, the basis of the asset in A's hands is reduced by $10.

(ii) Under subparagraph (1) of this paragraph, on June 1, 1963, the item of section 38 property ceases to be section 38 property with respect to A to the extent of $10 of the original $100 basis.

(d) *Retirements.* A retirement of section 38 property, including a normal retirement (as defined in paragraph (b) of §1.167(a)–8, relating to definition of normal and abnormal retirements), whether from a single asset account or a multiple asset account, and an abandonment, are dispositions for purposes of paragraph (a) of §1.47–1.

(e) *Conversion of section 38 property to personal use.* (1) If, for any taxable year subsequent to the credit year—

(i) A deduction for depreciation is allowable to the taxpayer with respect to only a part of section 38 property because such property is partially devoted to personal use, and

(ii) The part of the property (expressed as a percentage of its total basis (or cost)) with respect to which a deduction for depreciation is allowable for such taxable year is less than the part of the property with respect to which a deduction for depreciation was allowable in the credit year,

then such property shall be considered as having ceased to be section 38 property with respect to the taxpayer to such extent. Further, property ceases to be section 38 property with respect to the taxpayer to the extent that a deduction for depreciation thereon is disallowed under section 274 (relating to disallowance of certain entertainment, etc., expenses).

(2) *Examples.* Subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. (i) A, a calendar-year taxpayer, acquired and placed in service on January 1, 1962, an automobile with a basis of $2,400 and an estimated useful life of four years. In the taxable year 1962 the automobile was used by A 80 percent of the time in his trade or business and was used 20 percent of the time for personal purposes. Thus, for the taxable year 1962 only 80 percent of the basis of the automobile qualified as section 38 property since a deduction for depreciation was allowable to A only with respect to 80 percent of the basis of the automobile. In the taxable year 1963 the automobile is used by A only 60 percent of the time in his trade or business. Thus, for the taxable year 1963 a deduction for depreciation is allowable to A only with respect to 60 percent of the basis of the automobile.

(ii) Under subparagraph (1) of this paragraph, on January 1, 1963, the automobile ceases to be section 38 property with respect to A to the extent of 20 percent (80 percent minus 60 percent) of the $2,400 basis of the automobile.

Example 2. (i) The facts are the same as in example 1 and in addition for the taxable year 1964 a deduction for depreciation is allowable to A only with respect to 40 percent of the basis of the property.

(ii) Under subparagraph (1) of this paragraph, on January 1, 1964, the automobile ceases to be section 38 property with respect to A to the extent of 20 percent (60 percent minus 40 percent) of the $2,400 basis of the automobile.

[T.D. 6931, 32 FR 14032, Oct. 10, 1967, as amended by T.D. 7203, 37 FR 17128, Aug. 25, 1972]

§ 1.47–3 Exceptions to the application of § 1.47–1.

(a) *In general.* Notwithstanding the provisions of § 1.47–2, relating to ''disposition'' and ''cessation,'' paragraph (a) of § 1.47–1 shall not apply if paragraph (b) of this section (relating to transfers by reason of death), paragraph (c) of this section (relating to property destroyed by casualty), paragraph (d) of this section (relating to reselection of used section 38 property), paragraph (e) of this section (relating to transactions to which section 381(a) applies), paragraph (f) of this section (relating to mere change in form of conducting a trade or business), paragraph (g) of this section (relating to sale-and-leaseback transactions), or paragraph (h) of this section (relating to certain property replaced after Apr. 18, 1969) applies with respect to such disposition or cessation.

(b) *Transfers by reason of death*—(1) *General rule.* Notwithstanding the provisions of § 1.47–2, relating to ''disposition'' and ''cessation'', paragraph (a) of § 1.47–1 shall not apply to a transfer of section 38 property by reason of the death of the taxpayer. Thus, for example, with respect to section 38 property held in joint tenancy, paragraph (a) of § 1.47–1 shall not apply to the transfer of the deceased taxpayer's interest to the surviving joint tenant. If, under § 1.48–4, the lessor of new section 38 property made a valid election to treat the lessee as having purchased such property for purposes of the credit allowed by section 38, paragraph (a) of § 1.47–1 does not apply if, by reason of the death of the lessee, there is a termination of the lease and transfer of the leased property to the lessor, or there is an assignment of the lease and transfer of the leased property to another person. Moreover, paragraph (a) of § 1.47–1 does not apply to the transfer of a partner's interest in a partnership, a beneficiary's interest in an estate or trust, or shares of stock of a shareholder of an electing small business corporation (as defined in section 1371(b)) by reason of the death of such partner, beneficiary, or shareholder. Paragraph (a) of §1.47–1 shall not apply to property prior to his death even if the value of such gift is included in his gross estate for estate tax purposes (such as, a gift in contemplation of death under section 2035). The effect of this subparagraph is that any section 38 property held by a taxpayer at the time of his death is deemed to have been held by him for its entire estimated useful life.

(2) *Examples.* Subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. (i) A, an individual, acquired and placed in service on January 1, 1962, an item of section 38 property with a basis of $10,000 and an estimated useful life of eight years. On April 28, 1963, A dies and, as a result of A's death, his interest in such item of section 38 property is transferred to a testamentary trust pursuant to A's will, and on February 1, 1967, the trust is terminated and the item of section 38 property is transferred to the beneficiaries of the trust.

(ii) Under subparagraph (1) of this paragraph, paragraph (a) of §1.47–1 does not apply to the transfer, as a result of A's death, of his interest in such item of section 38 property to the testamentary trust. Moreover, paragraph (a) of §1.47–1 does not apply to the February 1, 1967, transfer of such item of section 38 property by the trust to its beneficiaries.

Example 2. (i) X Corporation, an electing small business corporation (as defined in section 1371(b)) which makes its returns on the basis of a calendar year, acquired and placed in service during 1962 an item of section 38 property. On December 31, 1962, X Corporation had 10 shares of stock outstanding which were owned as follows: A owned eight shares and B owned two shares. On December 31, 1962, 80 percent of the basis of the item of section 38 property was apportioned to A and 20 percent to B. On June 1, 1964, A dies and, as a result of A's death, his eight shares of stock in X Corporation are transferred to his wife. On July 10, 1965, X Corporation sells the item of section 38 property to Y Corporation.

(ii) Under subparagraph (1) of this paragraph, paragraph (a) of §1.47–1 does not apply to the transfer, as a result of A's death, of his eight shares of stock in X Corporation to his wife. Moreover, with respect to the July 10, 1965, sale paragraph (a) of §1.47–1 applies only to the 20 percent of the basis of the item of section 38 property which was apportioned to B.

(c) *Property destroyed by casualty*—(1) *Dispositions after April 18, 1969.* Notwithstanding the provisions of §1.47–2, relating to ''disposition'' and ''cessation'', paragraph (a) of §1.47–1 shall not apply to property which, after April 18, 1969, and before August 16, 1971, is disposed of or otherwise ceases to be section 38 property with respect to the taxpayer on account of its destruction or damage by fire, storm, shipwreck, or other casualty, or by reason of its theft.

(2) *Dispositions before April 19, 1969.* (i) In the case of property which, before April 19, 1969, is disposed of or otherwise ceases to be section 38 property with respect to the taxpayer on account of its destruction or damage by fire, storm, shipwreck or other casualty, or by reason of its theft, paragraph (a) of §1.47–1 shall apply except to the extent provided in subdivisions (ii) and (iii) of this subparagraph.

(ii) Paragraph (a) of §1.47–1 shall not apply if—

(*a*) Section 38 property is placed in service by the taxpayer to replace (within the meaning of paragraph (h) of §1.46–3) the destroyed, damaged, or stolen property, and

(*b*) The basis (or cost) of the section 38 property which is placed in service by the taxpayer to replace the destroyed, damaged, or stolen property is reduced under paragraph (h) of §1.46–3.

(iii) If property which would be section 38 property but for section 49 is placed in service by the taxpayer to replace the destroyed, damaged, or stolen property, then the provisions of paragraph (h) of this section (other than the requirement that the replacement take place within 6 months after the disposition) shall apply.

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

Example 1. (i) A acquired and placed in service on January 1, 1962, machine No. 1 which qualified as section 38 property with a basis of $30,000 and an estimated useful life of 6 years. The amount of qualified investment with respect to such machine was $20,000. For the taxable year 1962 A's credit earned of $1,400 was allowed under section 38 as a credit against its liability for tax. On January 1, 1963, machine No. 1 is completely destroyed by fire. On January 1, 1963, the adjusted basis of machine No. 1 in A's hands is $24,500. A receives $23,000 in insurance proceeds as compensation for the destroyed machine, and on February 15, 1964, A acquires and places in service machine No. 2, which qualifies as section 38 property, with a basis of $41,000 and an estimated useful life of 6 years to replace machine No. 1.

(ii) Under subparagraph (1) of this paragraph, paragraph (a) of §1.47–1 does not apply with respect to machine No. 1 since machine No. 2 is placed in service to replace machine No. 1 and the $41,000 basis of machine No. 2 is reduced, under paragraph (h) of §1.46–3, by $23,000. (See example 1 of paragraph (h)(3) of §1.46–3.)

Example 2. (i) The facts are the same as in example 1 except that A receives only $19,000 in insurance proceeds as compensation for the destroyed machine.

(ii) Although machine No. 2 is placed in service to replace machine No. 1, subparagraph (1) of this paragraph does not apply with respect to machine No. 1 since the basis of machine No. 2 is not reduced under paragraph (h) of §1.46–3. Paragraph (a) of §1.47–1 applies with respect to the January 1, 1963, destruction of machine No. 1. The actual useful life of machine No. 1 is 1 year. The recomputed qualified investment with respect to such machine is zero ($30,000 basis multiplied by zero applicable percentage) and A's recomputed credit earned for the taxable year 1962 is zero. The income tax imposed by chapter 1 of the Code on A for the taxable year 1963 is increased by $1,400.

(d) *Reselection of used section 38 property*—(1) *Reselection.* If—

(i) Used section 38 property (as defined in §1.48–3) the cost of which was taken into account in computing the taxpayer's qualified investment is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the estimated useful life which was taken into account in computing such qualified investment, and

(ii) For the taxable year in which the property described in subdivision (i) of this subparagraph was placed in service, the sum of (*a*) the cost of used section 38 property placed in service by the taxpayer, and (*b*) the cost of used section 38 property apportioned to such taxpayer exceeded $50,000,

then such taxpayer may treat the cost of any used section 38 property (regardless of its estimated useful life) which was not originally selected, under paragraph (c)(4) of §1.48–3, to be taken into account in computing qualified investment for such taxable year (or previously reselected under this subparagraph) as having been selected (in accordance with the principles of paragraph (c)(4)(ii) of §1.48–3) in place of the cost of the used section 38 property described in subdivision (i) of this subparagraph. Hereinafter such reselected property is referred to as ''newly selected used section 38 property''. For purposes of this subparagraph, the cost of used section 38 property apportioned to a taxpayer means the sum of the cost of used section 38 property apportioned to him by a trust, estate, or electing small business corporation (as defined in section 1371(b)), and his share of the cost of partnership used section 38 property, with respect to the taxable year of such trust, estate, corporation or partnership ending with or within such taxpayer's taxable year. In the case of a taxpayer to whom paragraph (c)(2) of §1.48–3 applied for the taxable year in which the property described in subdivision (i) of this subparagraph was placed in service, a $25,000 amount shall be substituted for the $50,000 amount referred to in subdivision (ii)(*b*) of this subparagraph, and in the case of a member of an affiliated group (as defined in subparagraph (6) of §1.48–3(e)) the amount apportioned to such member under paragraph (e) of §1.48–3 shall be substituted for such $50,000 amount.

(2) *Application of paragraph (a) of §1.47–1.* (i) If a taxpayer treats, under subparagraph (1) of this paragraph, the cost of any used section 38 property which was not originally selected as having been selected in place of the cost of used section 38 property described in subparagraph (1)(i) of this paragraph, then, not withstanding the provisions of §1.47–2 (relating to ''disposition'' and ''cessation''), paragraph (a) of §1.47–1 shall not apply to the property described in subparagraph (1)(i) of this paragraph to the extent of the cost of the newly selected used section 38 property.

(ii) If the cost of the used section 38 property described in subparagraph (1)(i) of this paragraph exceeds the cost of the newly selected used section 38 property, then the property described in subparagraph (1)(i) of this paragraph shall cease to be section 38 property with respect to the taxpayer to the extent of such excess.

(iii) If the newly selected used section 38 property is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the estimated useful life of the property described in subparagraph (1)(i) of this paragraph, then, unless he reselects other used section 38 property, paragraph (a) of §1.47–1 shall apply with respect to such newly selected used section 38 property. For purposes of recomputing qualified investment with respect to such newly selected used section 38 property the actual useful life shall be deemed to be the period beginning with the date on which the property described in subparagraph (1)(i) of this paragraph was placed in service by the taxpayer and ending with the date of the disposition or cessation with respect to such newly selected used section 38 property. See paragraph (c) of §1.47–1, relating to date placed in service and date of disposition or cessation.

(3) *Information requirement.* (i) If in any taxable year this paragraph applies to a taxpayer, such taxpayer shall attach to his income tax return for such taxable year a statement containing the information required by subdivision (ii) of this subparagraph.

(ii) The statement referred to in subdivision (i) of this subparagraph shall contain the following information:

(*a*) The taxpayer's name, address and taxpayer account number; and

(*b*) With respect to the originally selected used section 38 property and the newly selected used section 38 property, the month and year placed in service, cost, and estimated useful life.

(4) *Examples.* This paragraph may be illustrated by the following examples:

Example 1. (i) X Corporation purchased and placed in service on January 1, 1962, machines No. 1 and No. 2, which qualified as used section 38 property, each with a cost of $50,000 and an estimated useful life of eight years. The aggregate cost of used section 38 property taken into account by X Corporation in computing its qualified investment for the taxable year 1962 could not exceed $50,000; therefore, under paragraph (c)(4) of §1.48–3, X selected the $50,000 cost of machine No. 1 to be taken into account in computing its qualified investment for the taxable year 1962. The qualified investment with respect to machine No. 1 was $50,000. For the taxable year 1962 X's credit earned of $3,500 was allowed under section 38 as a credit against its liability for tax. On January 2, 1965, X Corporation sells machine No. 1 to Y Corporation.

(ii) Under subparagraph (1) of this paragraph, X Corporation treats the $50,000 cost of machine No. 2 as having been selected to be taken into account in computing its qualified investment for the taxable year 1962 in place of the $50,000 cost of machine No. 1. Therefore, under subparagraph (2)(i) of this paragraph, paragraph (a) of §1.47–1 does not apply to the January 2, 1965, disposition of machine No. 1.

Example 2. (i) The facts are the same as in example 1 and in addition X Corporation, on December 2, 1966, sells machine No. 2 to Z Corporation.

(ii) Under subparagraph (2)(iii) of this paragraph, paragraph (a) of §1.47–1 applies with respect to the December 2, 1966, disposition of machine No. 2. The actual useful life of machine No. 2 is four years and eleven months (that is, the period beginning on January 1, 1962, and ending on December 2, 1966). The recomputed qualified investment with respect to machine No. 2 is $16,667 ($50,000 cost multiplied by 33⅓ percent applicable percentage) and X Corporation's recomputed credit earned for the taxable year 1962 is $1,167. The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1966 is increased by the $2,333 decrease in its credit earned for the taxable year 1962 (that is, $3,500 original credit earned minus $1,167 recomputed credit earned).

Example 3. (i) The facts are the same as in example 1 except that machine No. 2 had a cost of $30,000.

(ii) Under subparagraph (1) of this paragraph, X Corporation treats the $30,000 cost of machine No. 2 as having been selected to be taken into account in computing its qualified investment for the taxable year 1962 in place of the $50,000 cost of machine No. 1. Therefore, under subparagraph (2)(i) of this paragraph, paragraph (a) of §1.47–1 does not apply to the January 2, 1965, disposition of machine No. 1 to the extent of $30,000 of the $50,000 cost of machine No. 1. However, under subparagraph (2)(ii) of this paragraph, paragraph (a) of §1.47–1 applies to the January 2, 1965, disposition of machine No. 1 to the extent of $20,000 (that is, $50,000 cost of machine No. 1 minus $30,000 cost of machine No. 2). The actual useful life of such $20,000 portion of machine No. 1 is three years (that is, the period beginning on January 1, 1962, and ending on January 2, 1965). The recomputed qualified investment with respect to the $20,000 portion of the cost of machine No. 1 is zero ($20,000 portion of the cost multiplied by zero applicable percentage) and X Corporation's recomputed credit earned for the taxable year 1962 is $2,100 (7 percent of $30,000). The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1965 is increased by the $1,400 decrease in its credit earned for the taxable year 1962 (that is, $3,500 original credit earned minus $2,100 recomputed credit earned).

(e) *Transactions to which section 381(a) applies*—(1) *General rule*. Notwithstanding the provisions of § 1.47–2, relating to "disposition" and "cessation", paragraph (a) of § 1.47–1 shall not apply to a disposition of section 38 property in a transaction to which section 381(a) (relating to carryovers in certain corporate acquisitions) applies. If the section 38 property described in the preceding sentence is disposed of, or otherwise ceases to be section 38 property with respect to the acquiring corporation, before the close of the estimated useful life which was taken into account in computing the transferor corporation's qualified investment, then paragraph (a) of § 1.47–1 shall apply to the acquiring corporation with respect to such section 38 property. For purposes of recomputing qualified investment with respect to such property its actual useful life shall be the period beginning with the date on which it was placed in service by the transferor corporation and ending with the date of the disposition by, or cessation with respect to, the acquiring corporation.

(2) *Examples*. This paragraph may be illustrated by the following examples:

Example 1. (i) X Corporation, a wholly owned subsidiary of Y Corporation, acquired and placed in service on January 1, 1962, an item of section 38 property with a basis of $12,000 and an estimated useful life of eight years. Both X and Y make their returns on the basis of a calendar year. The qualified investment with respect to such item was $12,000. For the taxable year 1962 X Corporation's credit earned of $840 was allowed under section 38 as a credit against its liability for tax. On January 15, 1967, X Corporation is liquidated under section 332 and all of its properties, including the item of section 38 property, are transferred to Y Corporation. The bases of the properties in the hands of Y Corporation are determined under section 334(b)(1).

(ii) Under subparagraph (1) of this paragraph, paragraph (a) of § 1.47–1 does not apply to the January 15, 1967, transfer to Y Corporation.

Example 2. (i) The facts are the same as in example 1 and in addition on February 2, 1968, Y Corporation sells the item of section 38 property to Z Corporation.

(ii) Under subparagraph (1) of this paragraph, paragraph (a) of § 1.47–1 does not apply to the January 15, 1967, transfer to Y Corporation. However, paragraph (a) of § 1.47 applies to the February 2, 1968, sale of the property by Y Corporation. The actual useful life of the property is six years and one month (that is, the period beginning on January 1, 1962, and ending on February 2, 1968).

(f) *Mere change in form of conducting a trade or business*—(1) *General rule*. (i) Notwithstanding the provisions of § 1.47–2, relating to "disposition" and "cessation", paragraph (a) of § 1.47–1 shall not apply to section 38 property which is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the estimated useful life which was taken into account in computing the taxpayer's qualified investment by reason of a mere change in the form of conducting the trade or business in which such section 38 property is used provided that the conditions set forth in subdivision (ii) of this subparagraph are satisfied.

(ii) The conditions referred to in subdivision (i) of this subparagraph are as follows:

(*a*) The section 38 property described in subdivision (i) of this subparagraph is retained as section 38 property in the same trade or business,

(*b*) The transferor (or in a case where the transferor is a partnership, estate, trust, or electing small business corporation, the partner, beneficiary, or shareholder) of such section 38 property retains a substantial interest in such trade or business,

(*c*) Substantially all the assets (whether or not section 38 property) necessary to operate such trade or business are transferred to the transferee to whom such section 38 property is transferred, and

(*d*) The basis of such section 38 property in the hands of the transferee is determined in whole or in part by reference to the basis of such section 38 property in the hands of the transferor. This subparagraph shall not apply to the transfer of section 38 property if paragraph (e) of this section, relating to transactions to which section 381 applies, applies with respect to such transfer.

(2) *Substantial interest.* For purposes of this paragraph, a transferor (or in a case where the transferor is a partnership, estate, trust, or electing small business corporation, the partner, beneficiary, or shareholder) shall be considered as having retained a substantial interest in the trade or business only if, after the change in form, his interest in such trade or business—

(i) Is substantial in relation to the total interest of all persons, or

(ii) Is equal to or greater than his interest prior to the change in form.

Thus, where a taxpayer owns a 5-percent interest in a partnership, and, after the incorporation of that partnership, the taxpayer retains at least a 5-percent interest in the corporation, the taxpayer will be considered as having retained a substantial interest in the trade or business as of the date of the change in form.

(3) *Property held for the production of income.* Subparagraph (1)(i) of this paragraph applies to section 38 property held for the production of income (within the meaning of section 167(a)(2)) as well as to section 38 property used in a trade or business.

(4) *Leased property.* In a case where a lessor of new section 38 property made a valid election, under §1.48–4, to treat the lessee as having purchased such property for purposes of the credit allowed by section 38, in determining whether subparagraph (1)(i) of this paragraph applies to an assignment of the lease and transfer of possession of such property, the condition contained in subparagraph (1)(ii)(*d*) of this paragraph is not applicable.

(5) *Disposition or cessation.* (i) If section 38 property described in subparagraph (1)(i) of this paragraph is disposed of by the transferee, or otherwise ceases to be section 38 property with respect to the transferee, before the close of the estimated useful life which was taken into account in computing the qualified investment of the transferor (or in a case where the transferor is a partnership, estate, trust, or electing small business corporation, the qualified investment of the partners, beneficiaries, or shareholders) then under paragraph (a) of §1.47–1 such property ceases to be section 38 property with respect to the transferor (or such partners, beneficiaries, or shareholders), and a recapture determination shall be made with respect to such property. For purposes of recomputing qualified investment with respect to such property, the actual useful life shall be the period beginning with the date on which it was placed in service by the transferor and ending with the date of the disposition by, or cessation with respect to, the transferee.

(ii) If in any taxable year the transferor (or in a case where the transferor is a partnership, estate, trust, or electing small business corporation, the partner, beneficiary, or shareholder) of the section 38 property described in subparagraph (1)(i) of this paragraph does not retain a substantial interest in the trade or business directly or indirectly (through ownership in other entities provided that such other entities' bases in such interest are determined in whole or in part by reference to the basis of such interest in the hands of the transferor) then, under paragraph (a) of §1.47–1, such property ceases to be section 38 property with respect to the transferor and he (or the partner, beneficiary, or shareholder) shall make a recapture determination. For purposes of recomputing qualified investment with respect to property described in this subdivision, its actual useful life shall be the period beginning with the date on which it was placed in service by the transferor and ending with the first date on which the transferor (or the partner, beneficiary, or shareholder) does not retain a substantial interest in the trade or business. Any taxpayer who seeks to establish his interest in a trade or business under the rule of this subdivision shall maintain adequate records to demonstrate his indirect interest in such trade or business after any such transfer or transfers.

(iii) In making a recapture determination under this subparagraph there shall be taken into account any prior recapture determinations with respect to the transferor in connection with the same property.

(iv) Notwithstanding subparagraph (1) of this paragraph and subdivision

(ii) of this subparagraph in the case of a mere change in the form of a trade or business, if the interest of a taxpayer in the trade or business is reduced but such taxpayer has retained a substantial interest in such trade or business, paragraph (a)(2) of § 1.47–4 (relating to electing small business corporations), paragraph (a)(2) of § 1.47–5 (relating to estates or trusts) or paragraph (a)(2) of § 1.47–6 (relating to partnerships) shall apply, as the case may be.

(6) *Examples.* This paragraph may be illustrated by the following examples in each of which it is assumed that the transfer satisfies the conditions of subparagraphs (1)(ii) (*a*), (*c*), and (*d*) of this paragraph.

Example 1. (i) On January 1, 1962, A, an individual, acquired and placed in service in his sole proprietorship an item of section 38 property with a basis of $12,000 and an estimated useful life of eight years. The qualified investment with respect to such item was $12,000. For the taxable year 1962 A's credit earned of $840 was allowed under section 38 as a credit against his liability for tax. On March 15, 1963, A transfers all of the assets used in his sole proprietorship to X Corporation, a newly formed corporation, in exchange for 45 percent of the stock of X Corporation.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a) of § 1.47–1 does not apply to the March 15, 1963, transfer to X Corporation.

Example 2. (i) The facts are the same as in example 1 and in addition on February 2, 1964, X Corporation sells the item of section 38 property to Y Corporation.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a) of § 1.47–1 does not apply to the March 15, 1963, transfer to X Corporation. However, under subparagraph (5)(i) of this paragraph, paragraph (a) of § 1.47–1 applies to the February 2, 1964, sale of the item of section 38 property by X Corporation to Y Corporation. The actual useful life of the property is two years and one month (that is, the period beginning on January 1, 1962, and ending on February 2, 1964). The recomputed qualified investment with respect to such property is zero ($12,000 basis multiplied by zero applicable percentage) and A's recomputed credit earned for the taxable year 1962 is zero. The income tax imposed by chapter 1 of the Code on A for 1964 is increased by the $840 decrease in his credit earned for the taxable year 1962 (that is, $840 credit earned minus zero recomputed credit earned).

Example 3. (i) On January 1, 1962, partnership ABC, which makes its returns on the basis of a calendar year, acquired and placed in service on item of section 38 property with a basis of $20,000 and an estimated useful life of eight years. Partnership ABC has 10 partners who make their returns on the basis of a calendar year and share partnership profits equally. Each partner's share of the basis of such item of section 38 property is 10 percent, that is, $2,000. On March 15, 1963, partnership ABC transfers all of the assets used in its trade or business to the X Corporation, a newly formed corporation, in exchange for all of the stock of X Corporation and immediately thereafter transfers 10 percent of such stock to each of the 10 partners.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a) of § 1.47–1 does not apply to the March 15, 1963 transfer by the ABC Partnership to X Corporation.

Example 4. (i) The facts are the same as in example 3 except that partnership ABC transfers 10 percent of the stock in X Corporation to each of 8 partners, 20 percent to partner A, and cash to partner B.

(ii) Under subparagraph (1)(i) of this paragraph, with respect to all of the partners (including partner A) except partner B, paragraph (a) of § 1.47–1 does not apply to the March 15, 1963, transfer by the ABC Partnership to X Corporation. Paragraph (a) of § 1.47–1 applies with respect to partner B's $2,000 share of the item of section 38 property. See paragraph (a)(1) of § 1.47–6.

Example 5. (i) X Corporation operates a manufacturing business and a separate personal service business. On January 1, 1962, X acquired and placed in service a truck, which qualified as section 38 property, in its manufacturing business. The truck had a basis of $10,000 and an estimated useful life of 8 years. On February 10, 1965, X transfers all the assets used in its manufacturing business to Partnership XY in exchange for a 50-percent interest in such partnership.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a) of § 1.47–1 does not apply to the February 10, 1965, transfer to Partnership XY.

(g) *Sale-and-leaseback transactions*—(1) *In general.* Notwithstanding the provisions of § 1.47–2, relating to ''disposition'' and ''cessation'', paragraph (a) of § 1.47–1 shall not apply where section 38 property is disposed of and as part of the same transaction is leased back to the vendor even though gain or loss is recognized to the vendor-lessee and the property ceases to be subject to depreciation in his hands. If paragraph (a) of § 1.47–1 applies with respect to such property subsequent to the transaction, the actual useful life shall begin with the date on which such property was first placed in service by the vendor-lessee as owner.

(2) *Special rule for progress expenditure property*. The sale and leaseback (or agreement or contract to leaseback) of progress expenditure property (including any contract rights to the property), in general, will be treated as a cessation described in section 47(a)(3)(A) with respect to the seller-lessee. However, a sale and leaseback (or agreement or contract to leaseback) will not be treated as a cessation to the extent qualified investment passed through to the lessee under section 48(d) in the year the property is placed in service equals or exceeds qualified progress expenditures for the property taken into account by the lessee. If a sale-leaseback transaction is treated as a cessation, qualified investment must be reduced and the credit recomputed, beginning with the most recent credit year (*i.e.*, the most recent year property is taken into account in computing qualified investment under §1.46–3 or 1.46–5). The amount of the reduction is the amount, if any, by which qualified progress expenditures taken into account by the lessee in all prior years exceeds qualified investment passed through to the lessee under section 48(d). This paragraph (g)(2) does not apply to any progress expenditure property that has been placed in service by a vendor-lessee (as described in paragraph (g)(1) of this section) prior to a sale-leaseback of that property in a transaction described in paragraph (g)(1) of this section.

(h) *Certain property replaced after April 18, 1969*—(1) *In general*. (i) If section 38 property is disposed of and property which is, for purposes of section 1033 and the regulations thereunder, similar or related in service or use to the property disposed of and which would be section 38 property but for the application of section 49 is placed in service to replace the property disposed of, the increase in income tax and adjustment of investment credit carryovers and carrybacks resulting from the recomputation under paragraph (a) of §1.47–1 shall be reduced (but not below zero) by the credit that would be allowed for the qualified investment of the replacement property (determined as if such property were section 38 property). The preceding sentence shall not apply unless the replacement takes place within 6 months after the disposition. If property otherwise qualifies as replacement property, it is immaterial that it is placed in service (for example, to undergo testing) before the replaced property is disposed of. The assignment by the taxpayer in his return of an estimated useful life to the replacement property in computing its qualified investment will be considered a representation by the taxpayer that he expects to retain the replacement property for its entire estimated useful life. If such property is disposed of before the end of such life, then the circumstances surrounding the replacement will be examined to determine whether the taxpayer's representation was in good faith and, if appropriate, the qualified investment of the replacement property will be recomputed for the year of replacement using the actual useful life of such property.

(ii) The provisions of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. On January 1, 1967, A, a calendar year taxpayer, acquired and placed in service a new machine with a basis of $100 and an estimated useful life of 8 years. A's qualified investment was $100 and his credit earned was $7, which was allowed as a credit against tax for 1967. On January 15, 1971. A disposed of the machine and replaced it with a similar new machine costing $75 and having an estimated useful life of 8 years. The new machine would be section 38 property but for section 49. Since the actual useful life of the original machine was at least 4 but less than 6 years, the recomputed qualified investment of the machine is $33.33 (33⅓ percent of $100) and under paragraph (a) of §1.47–1 the amount of recapture tax would be $4.67 ($7, the original credit earned, minus $2.33, the recomputed credit earned). However, under the provisions of this paragraph, the recapture tax is reduced (but not below zero) by the credit that would be allowed for the replacement property (determined as if such property were section 38 property). Under these facts the recapture tax is zero ($4.67, the recapture tax with respect to the original machine, minus $5.25, the credit that would be allowed on the new machine).

(2) *Leased property*. Property disposed of may be replaced with property leased from another, provided (i) an election with respect to the newly leased property could be made under section 48(d) but for section 49, and (ii) the lessee obtains the lessor's written

statement that he will not claim such property as replacement property under this paragraph. The statement of the lessor shall contain the information specified in subdivisions (i) through (vii) of §1.48–4(f)(1) and the statement (or a copy thereof) shall be retained in the records of the lessor and the lessee for a period of at least 3 years after the property is transferred to the lessee.

[T.D. 6931, 32 FR 14033, Oct. 10, 1967, as amended by T.D. 7126, 36 FR 11192, June 10, 1971; T.D. 7203; 37 FR 17128, Aug. 25, 1972; T.D. 8183, 53 FR 6625, Mar. 2, 1988]

§ 1.47–4 Electing small business corporation.

(a) *In general*—(1) *Disposition or cessation in hands of corporation.* If an electing small business corporation (as defined in section 1371(b)) or a former electing small business corporation disposes of any section 38 property (or if any section 38 property otherwise ceases to be section 38 property in the hands of the corporation) before the close of the estimated useful life which was taken into account in computing qualified investment with respect to such property, a recapture determination shall be made with respect to each shareholder who is treated, under §1.48–5, as a taxpayer with respect to such property. Each such recapture determination shall be made with respect to the pro rata share of the basis (or cost) of such property taken into account by such shareholder in computing his qualified investment. For purposes of each such recapture determination the actual useful life of such property shall be the period beginning with the date on which it was placed in service by the electing small business corporation and ending with the date of the disposition or cessation. In making a recapture determination under this subparagraph there shall be taken into account any prior recapture determinations made with respect to the shareholder in connection with the same property. For definition of ''recapture determination'' see paragraph (a)(1) of §1.47–1.

(2) *Disposition of shareholder's interest.* (i) If—

(*a*) The basis (or cost) of section 38 property is apportioned, under §1.48–5, to a shareholder of an electing small business corporation who takes such basis (or cost) into account in computing his qualified investment, and

(*b*) After the end of the shareholder's taxable year in which such apportionment was taken into account and before the close of the estimated useful life of the property, such shareholder's proportionate stock interest in such corporation is reduced (for example, by a sale or redemption, or by the issuance of additional shares) below the percentage specified in subdivision (ii) of this subparagraph,

then, on the date of such reduction such section 38 property ceases to be section 38 property with respect to such shareholder to the extent of the actual reduction in such shareholder's proportionate stock interest. (For example, if $100 of the basis of section 38 property was apportioned to a shareholder and if his proportionate stock interest is reduced from 60 percent to 30 percent (that is, 50 percent of his original interest), then such property shall be treated as having ceased to be section 38 property to the extent of $50.) Accordingly, a recapture determination shall be made with respect to such shareholder. For purposes of such recapture determination the actual useful life of such property shall be the period beginning with the date on which it was placed in service by the electing small business corporation and ending with the date on which it is treated as having ceased to be section 38 property with respect to the shareholder. In making a recapture determination under this subparagraph there shall be taken into account any prior recapture determination made with respect to the shareholder in connection with the same property.

(ii) The percentage referred to in subdivision (i)(*b*) of this subparagraph is 66⅔ percent of the shareholder's proportionate stock interest in the corporation on the date of the apportionment under §1.48–5. However, once property has been treated under this subparagraph as having ceased to be section 38 property to any extent the percentage referred to shall be 33⅓ percent of the shareholder's proportionate stock interest in the corporation on the date of the apportionment under §1.48–5.

(iii) In determining a shareholder's proportionate stock interest in a former electing small business corporation for purposes of this subparagraph, the shareholder shall be considered to own stock in such corporation which he owns directly or indirectly (through ownership in other entities provided such other entities' bases in such stock are determined in whole or in part by reference to the basis of such stock in the hands of the transferor). For example, if A, who owns all of the 100 shares of the outstanding stock of corporation X, a corporation which was formerly an electing small business corporation, transfers on November 1, 1966, 70 shares of X stock to corporation Y in exchange for 90 percent of the stock of Y in a transaction to which section 351 applies, then, for purposes of subdivision (i) of this subparagraph, A shall be considered to own 93 percent of the stock of X, 30 percent directly and 63 percent indirectly (*i.e.*, 90 percent of 70). Any taxpayer who seeks to establish his interest in the stock of a former electing small business corporation under the rule of this subdivision shall maintain adequate records to demonstrate his indirect interest in the corporation after any such transfer or transfers.

(b) *Election of a small business corporation under section 1372*—(1) *General rule*. If a corporation makes a valid election under section 1372 to be an electing small business corporation (as defined in section 1371(b)), then on the last day of the taxable year immediately preceding the first taxable year for which such election is effective, any section 38 property the basis (or cost) of which was taken into account in computing the corporation's qualified investment in taxable years prior to the first taxable year for which the election is effective (and which has not been disposed of or otherwise ceased to be section 38 property with respect to the corporation prior to such last day) shall be considered as having ceased to be section 38 property with respect to such corporation and §1.47–1 shall apply. However, if the corporation and each of the persons who are shareholders of the corporation on the first day of the first taxable year for which the election under section 1372 is to be effective, or on the date of such election, whichever is later, execute the agreement specified in subparagraph (2) of this paragraph, §1.47–1 shall not apply to any such section 38 property by reason of the election by the corporation under section 1372.

(2) *Agreement of shareholders and corporation*. (i) The agreement referred to in subparagraph (1) of this paragraph shall be signed by the shareholders and the corporation, and shall recite that, in the event the section 38 property described in subparagraph (1) of this paragraph is later disposed of by, or ceases to be section 38 property with respect to, the corporation during a taxable year of the corporation for which the election under section 1372 is effective, each such signer agrees (*a*) to notify the district director of such disposition or cessation, and (*b*) to be jointly and severally liable to pay to the district director an amount equal to the increase in tax provided by section 47. The amount of such increase shall be determined as if such property had ceased to be section 38 property as of the last day of the taxable year immediately preceding the first taxable year for which the election under section 1372 is effective, except that the actual useful life (within the meaning of paragraph (a) of §1.47–1) of the property shall be considered to have ended on the date of the actual disposition by, or cessation in the hands of, the electing small business corporation.

(ii) The agreement shall set forth the name, address, and taxpayer account number of each party and the internal revenue district in which each such party files his or its income tax return for the taxable year which includes the last day of the corporation's taxable year immediately preceding the first taxable year for which the election under section 1372 is effective. The agreement may be signed on behalf of the corporation by any person who is duly authorized. The agreement shall be filed with the district director with whom the corporation files its income tax return for its taxable year immediately preceding the first taxable year for which the election under section 1372 is effective and shall be filed on or before the due date (including extensions of time) of such return. However, if the due date (including extensions of time) of such income tax return is on or before September 1, 1967, the agreement may be filed on or before December 31, 1967. For purposes of the two preceding sentences, the district director may, if good cause is shown, permit the agreement to be filed on a later date.

(c) *Examples*. This section may be illustrated by the following examples in each of which it is assumed that X Corporation, an electing small business corporation which makes its returns on the basis of the calendar year, acquired and placed in service on June 1, 1962, three items of section 38 property. The basis and estimated useful life of each item of section 38 property are as follows:

Asset No.	Basis	Estimated useful life (Years)
1	$30,000	4
2	30,000	6
3	30,000	8

On December 31, 1962, X Corporation had 20 shares of stock outstanding which were owned equally by A and B who make their returns on the basis of a calendar year. Under §1.48–5, the total bases of section 38 properties was apportioned to the shareholders of X Corporation as follows:

	Useful life category		
	4 to 6 years	6 to 8 years	8 years or more
Total bases	$30,000	$30,000	$30,000
Shareholder A (10/20)	15,000	15,000	15,000
Shareholder B (10/20)	15,000	15,000	15,000

Assuming that during 1962 shareholders A and B did not place in service any section 38 property and that they did not own any interests in other electing small business corporations, partnerships, estates, or trusts, the qualified investment of each shareholder is $30,000, computed as follows:

Basis	Applicable percentage	Qualified investment
$15,000	33⅓	$5,000
$15,000	66⅔	10,000
$15,000	100	15,000
		30,000

For the taxable year 1962, each shareholder's credit earned of $2,100 (7 percent of $30,000) was allowed under section 38 as a credit against his liability for tax.

Example 1. (i) On December 2, 1965, X Corporation sells asset No. 3 to Y Corporation.

(ii) The actual useful life of asset No. 3 is three years and six months. The recomputed qualified investment with respect to each shareholder's share of the basis of asset No. 3 is zero ($15,000 share of basis multiplied by zero applicable percentage) and for the taxable year 1962 each shareholder's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on each of the shareholders for the taxable year 1965 is increased by the $1,050 decrease in his credit earned for the taxable year 1962 (that is, $2,100 original credit earned minus $1,050 recomputed credit earned).

Example 2. (i) On December 3, 1964, shareholder A sells 5 of his 10 shares of stock in X Corporation to C, and on December 3, 1965, A sells his remaining 5 shares of stock to D. In addition, on January 2, 1966, X Corporation sells asset No. 3 to Y Corporation.

(ii) Under paragraph (a)(2) of this section, on December 3, 1964, 50 percent of the share of the basis of each of the three items of section 38 property ceases to be section 38 property with respect to shareholder A since immediately after the December 3, 1964, sale A's proportionate stock interest in X Corporation is reduced to 50 percent of the proportionate stock interest in X Corporation which he held on December 31, 1962. The actual useful life of the share of the bases of the section 38 properties which cease to be section 38 property with respect to A is two years and six months (that is, the period beginning with June 1, 1962, and ending with December 3, 1964). A's recomputed qualified investment with respect to such properties is $15,000, computed as follows:

Basis	Applicable percentage	Recomputed qualified investment
$7,500	33⅓	$2,500
$7,500	66⅔	5,000
$7,500	100	7,500
		15,000

For the taxable year 1962 shareholder A's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on shareholder A for the taxable year 1964 is increased by the $1,050 decrease in his credit earned for the taxable year 1962 (that is, $2,100 original credit earned minus $1,050 recomputed credit earned).

(iii) Under paragraph (a)(2) of this section, on December 3, 1965, the remaining 50 percent of the share of the basis of each of the three items of section 38 property ceases to be section 38 property with respect to shareholder A since immediately after the December 3, 1965, sale A's proportionate stock interest in X Corporation is reduced to zero. The actual useful life of the share of the bases of the section 38 properties which cease to be section 38 property with respect to A is three years and six months (that is, the period beginning with June 1, 1962, and ending with December 3, 1965). A's recomputed qualified investment with respect to such properties is zero. For the taxable year 1962 shareholder A's recomputed credit earned is zero. The income tax imposed by chapter 1 of the Code on shareholder A for the taxable year 1965 is increased by $1,050 (that is, $2,100 ($2,100 original credit earned minus zero recomputed credit earned) reduced by the $1,050 increase in tax for 1964).

(iv) The actual useful life of asset No. 3 which was sold on January 2, 1966, is three years and seven months. The recomputed qualified investment with respect to B's share of the basis of asset No. 3 is zero ($15,000 share of basis multiplied by zero applicable percentage) and for the taxable year 1962, B's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on shareholder B for the taxable year 1966 is increased by the $1,050 decrease in his credit earned for the taxable year 1962 ($2,100 original credit earned minus $1,050 recomputed credit earned). The sale of asset No. 3 on January 2, 1966, by X Corporation has no effect on A.

(d) *Termination or revocation of an election under section 1372.* Section 38 property shall not be considered to be disposed of or to have ceased to be section 38 property solely by reason of a termination or revocation of a corporation's election under section 1372.

[T.D. 6931, 32 FR 14035, Oct. 10, 1967]

§ 1.47–5 Estates and trusts.

(a) *In general*—(1) *Disposition or cessation in hands of estate or trust.* If an estate or trust disposes of any section 38 property (or if any section 38 property otherwise ceases to be section 38 property in the hands of the estate or trust) before the close of the estimated useful life which was taken into account in computing qualified investment with respect to such property, a recapture determination shall be made with respect to the estate or trust, and each beneficiary who is treated, under §1.48–6, as a taxpayer with respect to such property. Each such recapture determination shall be made with respect to the share of the basis (or cost) of such property taken into account by such estate or trust and such beneficiary in computing its or his each such recapture determination the actual useful life of such property shall be the period beginning with the date on which it was placed in service by the estate or trust and ending with the date of the disposition or cessation. In making a recapture determination under this subparagraph with respect to a taxpayer there shall be taken into account any prior recapture determinations made with respect to such taxpayer in connection with the same property. For definition of ''recapture determination'' see paragraph (a)(1) of §1.47–1.

(2) *Disposition of interest.* (i) If—

(*a*) The basis (or cost) of section 38 property is apportioned, under §1.48–6, to an estate or trust which, or to a beneficiary of an estate or trust who, takes such basis (or cost) into account in computing his qualified investment, and

(*b*) After the date on which such section 38 property was placed in service by the estate or trust and before the close of the estimated useful life of the property, such estate's, trust's, or such beneficiary's proportionate interest in the income of the estate or trust is reduced (for example, by a sale, or by the terms of the estate or trust instrument) below the percentage specified in subdivision (ii) of this subparagraph, then, on the date of such reduction, such section 38 property ceases to be section 38 property with respect to such estate, trust, or beneficiary to the extent of the actual reduction in such estate's, trust's, or beneficiary's proportionate interest in the income of the estate or trust. (For example, if $100 of the basis of section 38 property was apportioned to a beneficiary and if his proportionate interest in the income of the estate or trust is reduced from 60 percent to 30 percent (that is, 50 percent of his original interest), then such property shall be treated as having ceased to be section 38 property to the extent of $50). Accordingly, a recapture determination shall be made with respect to such estate, trust, or beneficiary. For purposes of such recapture determination the actual useful life of such property shall be the period beginning with the date on which it was placed in service by the estate or trust and ending with the date on which it is treated as having ceased to be section 38 property with respect to the estate, trust, or beneficiary. In making a recapture determination under this subparagraph there shall be taken into account any prior recapture determination made with respect to the estate, trust, or beneficiary in connection with the same property.

(ii) The percentage referred to in subdivision (i)(*b*) of this subparagraph is 66⅔ percent of the estate's, trust's, or beneficiary's proportionate interest in the income of the estate or trust for the taxable year of the apportionment under §1.48–6. However, once property has been treated under this subparagraph as having ceased to be section 38 property to any extent the percentage referred to shall be 33⅓ percent of the estate's, trust's, or beneficiary's proportionate interest in the income of the estate or trust for the taxable year of the apportionment under §1.48–6.

(iii) In determining a beneficiary's proportionate interest in the income of an estate or trust for purposes of this subparagraph, the beneficiary shall be considered to own any interest in such an estate or trust which he owns directly or indirectly (through ownership in other entities provided such other entities' bases in such interest are determined in whole or in part by reference to the basis of such interest in the hands of the beneficiary). For example, if A, whose proportionate interest in the income of trust X is 30 percent, transfers all of such interest to corporation Y in exchange for all of the stock of Y in a transaction to which section 351 applies, then, for purposes of subdivision (i) of this subparagraph, A shall be considered to own a 30-percent interest in trust X. Any taxpayer who seeks to establish his interest in an estate or trust under the rule of this subdivision shall maintain adequate records to demonstrate his indirect interest in the estate or trust after any such transfer or transfers.

(b) *Examples*. Paragraph (a) of this section may be illustrated by the following examples in each of which it is assumed that XYZ Trust, which makes its returns on the basis of the calendar year, acquired and placed in service on June 1, 1962, three items of section 38 property. The basis and estimated useful life of each item of section 38 property are as follows:

Asset No.	Basis	Estimated useful life (Years)
1	$30,000	4
2	30,000	6
3	30,000	8

For the taxable year 1962 the income of XYZ Trust is $20,000, which is allocable equally to XYZ Trust and beneficiary A. Beneficiary A makes his returns on the basis of a calendar year. Under §1.48–6, the total bases of the section 38 properties was apportioned to XYZ Trust and beneficiary A as follows:

		Useful life category		
		4 to 6 years	6 to 8 years	8 years or more
Total bases		$30,000	$30,000	$30,000
	($10,000)	15,000	15,000	15,000
XYZ Trust	($20,000)			
Beneficiary A	($10,000)	15,000	15,000	15,000
	($20,000)			

Assuming that during 1962 beneficiary A did not place in service any section 38 property and that he did not own any interests in other estates, trusts, electing small business corporations, or partnerships, the qualified investment of XYZ Trust and of beneficiary A is $30,000 each, computed as follows:

Basis	Applicable percentage	Qualified investment
$15,000	33⅓	$5,000

Basis	Applicable percentage	Qualified investment
$15,000	66⅔	10,000
$15,000	100	15,000
		30,000

For the taxable year 1962, XYZ Trust and beneficiary A each had a credit earned of $2,100 (7 percent of $30,000). Each such credit earned was allowed under section 38 as a credit against the liability for tax.

Example 1. (i) On December 2, 1965, XYZ Trust sells asset No. 3 to X Corporation.

(ii) The actual useful life of asset No. 3 is three years and six months. The recomputed qualified investment with respect to XYZ Trust's and beneficiary A's share of the basis of asset No. 3 is zero ($15,000 share of basis multiplied by zero applicable percentage) and for the taxable year 1962, XYZ Trust's and beneficiary A's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on XYZ Trust and on beneficiary A for the taxable year 1965 is increased by the $1,050 decrease in his credit earned for the taxable year 1962 (that is, $2,100 original credit earned minus $1,050 recomputed credit earned).

Example 2. (i) On December 3, 1964, beneficiary A sells 50 percent of his interest in the income of XYZ Trust to B, and on December 3, 1965, A sells his remaining 50 percent interest to C. In addition, on January 2, 1966, XYZ Trust sells asset No. 3 to Y Corporation.

(ii) Under paragraph (a)(2) of this section, on December 3, 1964, 50 percent of the basis of each of the three items of section 38 property ceases to be section 38 property with respect to beneficiary A since immediately after the December 3, 1964, sale A's proportionate interest in the income of XYZ Trust is reduced to 50 percent of his proportionate interest in the income of XYZ Trust for the taxable year 1962. The actual useful life of the share of the bases of the section 38 properties which cease to be section 38 property with respect to A is two years and six months (that is, the period beginning with June 1, 1962, and ending with December 3, 1964). Beneficiary A's recomputed qualified investment with respect to such properties is $15,000, computed as follows:

Basis	Applicable percentage	Qualified investment
$7,500	33⅓	$2,500
$7,500	66⅔	5,000
$7,500	100	7,500
		15,000

For the taxable year 1962 beneficiary A's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on beneficiary A for the taxable year 1964 is increased by the $1,050 decrease in his credit earned for the taxable year 1962 (that is, $2,100 original credit earned minus $1,050 recomputed credit earned).

(iii) Under paragraph (a)(2) of this section, on December 3, 1965, the remaining 50 percent of the share of the basis of each of the three items of section 38 property ceases to be section 38 property with respect to beneficiary A since immediately after the December 3, 1965, sale A's proportionate interest in the income of XYZ Trust is reduced to zero. The actual useful life of the share of the basis of the section 38 properties which cease to be section 38 property with respect to A is three years and six months (that is, the period beginning with June 1, 1962, and ending with December 3, 1965). A's recomputed qualified investment with respect to such properties is zero. For the taxable year 1962 beneficiary A's recomputed credit earned is zero. The income tax imposed by chapter 1 of the Code on beneficiary A for the taxable year 1965 is increased by $1,050 (that is, $2,100 ($2,100 original credit earned minus zero recomputed credit earned) reduced by the $1,050 increase in tax for 1964).

(iv) The actual useful life of asset No. 3 which was sold on January 2, 1966, is three years and seven months. The recomputed qualified investment with respect to XYZ Trust's share of the basis of asset No. 3 is zero ($15,000 share of basis multiplied by zero applicable percentage) and for the taxable year 1962, XYZ Trust's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on XYZ Trust for the taxable year 1966 is increased by the $1,050 decrease in its credit earned for the taxable year 1962 ($2,100 original credit earned minus $1,050 recomputed credit earned). The sale of asset No. 3 on January 2, 1966, has no effect on A.

[T.D. 6931, 32 FR 14037, Oct. 10, 1967]

§ 1.47–6 Partnerships.

(a) *In general*—(1) *Disposition or cessation in hands of partnership.* If a partnership disposes of any partnership section 38 property (or if any partnership section 38 property otherwise ceases to be section 38 property in the hands of the partnership) before the close of the estimated useful life which was taken into account in computing qualified investment with respect to such property, a recapture determination shall be made with respect to each partner who is treated, under paragraph (f) of §1.46–3, as a taxpayer with respect to such property. Each such recapture determination shall be made with respect to the share of the basis (or cost) of such property taken into account by such partner in computing his qualified investment. For purposes of each such recapture determination the actual useful life of such property shall be the period beginning with the date on which it was placed in service by the partnership and ending with the date of the disposition or cessation. In making a recapture determination under this subparagraph there shall be taken into account any prior recapture determinations made with respect to the partner in connection with the same property. For definition of ''recapture determination'' see paragraph (a)(1) of §1.47–1.

(2) *Disposition of partner's interest.* (i) If—

(*a*) The basis (or cost) of partnership section 38 property is taken into account by a partner in computing his qualified investment, and

(*b*) After the date on which such partnership section 38 property was placed in service by the partnership and before the close of the estimated useful life of the property, such partner's proportionate interest in the general profits of the partnership (or in the particular item of property) is reduced (for example, by a sale, by a change in the partnership agreement, or by the admission of a new partner) below the percentage specified in subdivision (ii) of this subparagraph, then, on the date of such reduction such partnership section 38 property ceases to be section 38 property with respect to such partner to the extent of the actual reduction in such partner's proportionate interest in the general profits of the partnership (or in the particular item of property). (For example, if $100 of the basis of section 38 property was taken into account by a partner and if his proportionate interest in the general profits of the partnership is reduced from 60 percent to 30 percent (that is, 50 percent of his original interest), then such property shall be treated as having ceased to be section 38 property to the extent of $50.) Accordingly, a recapture determination shall be made with respect to such partner. For purposes of such recapture determination the actual useful life of such property shall be the period beginning with the date on which it was placed in service by the partnership and ending with the date on which it is treated as having ceased to be section 38 property with respect to the partner. In making a recapture determination under this subparagraph there shall be taken into account any prior recapture determination made with respect to the partner in connection with the same property.

(ii) The percentage referred to in subdivision (i)(*b*) of this subparagraph is 66⅔ percent of the partner's proportionate interest in the general profits of the partnership (or in the particular item of property) for the year in which such property was placed in service. However, once property has been treated under this subparagraph as having ceased to be section 38 property to any extent the percentage referred to shall be 33⅓ percent of the partner's proportionate interest in the general profits of the partnership (or in the particular item of property) for the year in which such property was placed in service.

(iii) In determining a partner's proportionate interest in the general profits of a partnership for purposes of this subparagraph, the partner shall be considered to own any interest in such a partnership which he owns directly or indirectly (through ownership in other entities provided the other entities' bases in such interest are determined in whole or in part by reference to the basis of such interest in the hands of the partner). For example, if A, whose proportionate interest in the general profits of partnership X is 20 percent, transfers all of such interest to corporation Y in exchange for all of the stock of Y in a transaction to which section 351 applies, then, for purposes of subdivision (i) of this subparagraph, A shall be considered to own a 20-percent interest in partnership X. Any taxpayer who seeks to establish his interest in a partnership under the rule of this subdivision shall maintain adequate records to demonstrate his indirect interest in the partnership after any such transfer or transfers.

(b) *Examples.* Paragraph (a) of this section may be illustrated by the following examples in each of which it is assumed that ABC Partnership, which makes its returns on the basis of the calendar year, acquired and placed in service on June 1, 1962, three items of section 38 property. The basis and estimated useful life of each item of section 38 property are as follows:

Asset No.	Basis	Estimated useful life Years
1	$30,000	4
2	30,000	6
3	30,000	8

Partners A and B, who make their returns on the basis of a calendar year, share the profits and losses of ABC Partnership equally. Under paragraph (f)(2) of §1.46–3, each partner's share of the basis of the partnership section 38 property is as follows:

Asset No.	Estimated useful life (years)	Basis	Partners share of basis	
			A 50 percent	B 50 percent
1	4	$30,000	$15,000	$15,000
2	6	30,000	15,000	15,000
3	8	30,000	15,000	15,000

Assuming that during 1962 partners A and B did not place in service any section 38 property and that they did not own any interests in other partnerships, electing small business corporations, estates, or trusts, the qualified investment of each partner is $30,000, computed as follows:

Partnership asset No.	Share of basis	Applicable percentage	Qualified investment
1	$15,000	33⅓	$5,000
2	15,000	66⅔	10,000
3	15,000	100	15,000
			30,000

For the taxable year 1962, each partner's credit earned of $2,100 (7 percent of $30,000) was allowed under section 38 as a credit against his liability for tax.

Example 1. (i) On December 2, 1965, ABC Partnership sells asset No. 3 to X Corporation.

(ii) The actual useful life of asset No. 3 is three years and six months. The recomputed qualified investment with respect to each partner's share of the basis of asset No. 3 is zero ($15,000 shares of basis multiplied by zero applicable percentage) and for the taxable year 1962, each partner's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on each of the partners for the taxable year 1965 is increased by the $1,050 decrease in his credit earned for the taxable year 1962 (that is, $2,100 original credit earned minus $1,050 recomputed credit earned).

Example 2. (i) On December 3, 1964, partner A sells one-half of his 50 percent interest in ABC Partnership to C, and on December 3, 1965, A sells the remaining one- half of his interest to D. In addition, on January 2, 1966, ABC Partnership sells asset No. 3 to X Corporation.

(ii) Under paragraph (a)(2) of this section, on December 3, 1964, 50 percent of the basis of each of the three items of section 38 property ceases to be section 38 property with respect to partner A since immediately after the December 3, 1964, sale A's proportionate interest in the general profits of ABC Partnership is reduced to 50 percent of his proportionate interest in the general profits of ABC Partnership for 1962. The actual useful life of the share of the basis of each of the section 38 properties which cease to be section 38 property with respect to A is two years and six months (that is, the period beginning with June 1, 1962, and ending with December 3, 1964). Partner A's recomputed qualified investment with respect to such properties is $15,000, computed as follows:

Partnership asset No.	Share of basis	Applicable percentage	Qualified investment
1	$7,500	33⅓	$2,500
2	7,500	66⅔	5,000
3	7,500	100	7,500
			15,000

For the taxable year 1962 partner A's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on partner A for the taxable year 1964 is increased by the $1,050 decrease in his credit earned for the taxable year 1962 (that is, $2,100 original credit earned minus $1,050 recomputed credit earned).

(iii) Under paragraph (a)(2) of this section, on December 3, 1965, the remaining 50 percent of the share of the basis of each of the three items of section 38 property ceases to be section 38 property with respect to partner A since immediately after the December 3, 1965, sale A's proportionate interest in the general profits of ABC Partnership is reduced to zero. The actual useful life of the share of the bases of the section 38 properties which cease to be section 38 property with respect to A is three years and six months (that is, the period beginning with June 1, 1962, and ending with December 3, 1965). A's recomputed qualified investment with respect to such properties is zero. For the taxable year 1962 partner A's recomputed credit earned is zero. The income tax imposed by chapter 1 of the Code on partner A for the taxable year 1965 is increased by $1,050 (that is, $2,100 ($2,100 original credit earned minus zero recomputed credit earned) reduced by the $1,050 increase in tax for 1964).

(iv) The actual useful life of asset No. 3 which was sold on January 2, 1966, is three years and seven months. The recomputed qualified investment with respect to partner

B's share of the basis of asset No. 3 is zero ($15,000 share of basis multiplied by zero applicable percentage) and for the taxable year 1962, partner B's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on partner B for the taxable year 1966 is increased by the $1,050 decrease in his credit earned for the taxable year 1962 ($2,100 original credit earned minus $1,050 recomputed credit earned). The sale of asset No. 3 on January 2, 1966, has no effect on A.

[T.D. 6931, 32 FR 14039, Oct. 10, 1967]

§ 1.48–1 Definition of section 38 property.

(a) *In general.* Property which qualifies for the credit allowed by section 38 is known as "section 38 property". Except as otherwise provided in this section, the term "section 38 property" means property (1) with respect to which depreciation (or amortization in lieu of depreciation) is allowable to the taxpayer, (2) which has an estimated useful life of 3 years or more (determined as of the time such property is placed in service), and (3) which is (i) tangible personal property, (ii) other tangible property (not including a building and its structural components) but only if such other property is used as an integral part of manufacturing, production, or extraction, or an integral part of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services by a person engaged in a trade or business of furnishing any such service, or is a research or storage facility used in connection with any of the foregoing activities, (iii) an elevator or escalator which satisfies the conditions of section 48(a)(1)(C), or (iv) in the case of a qualified rehabilitated building, that portion of the basis which is attributable to qualified rehabilitation expenditures. The determination of whether property qualifies as section 38 property in the hands of the taxpayer for purposes of the credit allowed by section 38 must be made with respect to the first taxable year in which such property is placed in service by the taxpayer. See paragraph (d) of § 1.46–3. For the meaning of "estimated useful life", see paragraph (e) of § 1.46–3. In the case of property which is not described in section 50, this paragraph shall be applied by substituting "4 years" for "3 years".

(b) *Depreciation allowable.* (1) Property (with the exception of property described in section 48(a)(1)(F) and paragraph (p) of this section) is not section 38 property unless a deduction for depreciation (or amortization in lieu of depreciation) with respect to such property is allowable to the taxpayer for the taxable year. A deduction for depreciation is allowable if the property is of a character subject to the allowance for depreciation under section 167 and the basis (or cost) of the property is recovered through a method of depreciation, including, for example, the unit of production method and the retirement method as well as methods of depreciation which measure the life of the property in terms of years. If property is placed in service (within the meaning of paragraph (d) of § 1.46–3) in a trade or business (or in the production of income), but under the taxpayer's depreciation practice the period for depreciation with respect to such property begins in a taxable year subsequent to the taxable year in which such property is placed in service, then a deduction for depreciation shall be treated as allowable with respect to such property in the earlier taxable year (or years). Thus, for example, if a machine is placed in service in a trade or business in 1963, but the period for depreciation with respect to such machine begins in 1964, because the taxpayer uses an averaging convention (see § 1.167(a)–10) in computing depreciation, then, for purposes of determining whether the machine qualifies as section 38 property, a deduction for depreciation shall be treated as allowable in 1963.

(2) If, for the taxable year in which property is placed in service, a deduction for depreciation is allowable to the taxpayer only with respect to a part of such property, then only the proportionate part of the property with respect to which such deduction is allowable qualifies as section 38 property for the purpose of determining the amount of credit allowable under section 38. Thus, for example, if property is used 80 percent of the time in a trade or business and is used 20 percent of the time for personal purposes, only 80

percent of the basis (or cost) of such property qualifies as section 38 property. Further, property does not qualify to the extent that a deduction for depreciation thereon is disallowed under section 274 (relating to disallowance of certain entertainment, etc., expenses).

(3) If the cost of property is not recovered through a method of depreciation but through a deduction of the full cost in one taxable year, for purposes of subparagraph (1) of this paragraph a deduction for depreciation with respect to such property is not allowable to the taxpayer. However, if an adjustment with respect to the income tax return for such taxable year requires the cost of such property to be recovered through a method of depreciation, a deduction for depreciation will be considered as allowable to the taxpayer.

(4) If depreciation sustained on property is not an allowable deduction for the taxable year but is added to the basis of property being constructed, reconstructed, or erected by the taxpayer, for purposes of subparagraph (1) of this paragraph a deduction for depreciation shall be treated as allowable for the taxable year with respect to the property on which depreciation is sustained. Thus, if $1,000 of depreciation sustained with respect to property No. 1, which is placed in service in 1964 by taxpayer A, is not allowable to A as a deduction for 1964 but is added to the basis of property being constructed by A (property no. 2), for purposes of subparagraph (1) of this paragraph a deduction for depreciation shall be treated as allowable to A for 1964 with respect to property no. 1. However, the $1,000 amount is not included in the basis of property no. 2 for purposes of determining A's qualified investment with respect to property no. 2. See paragraph (c)(1) of §1.46–3.

(c) *Definition of tangible personal property.* If property is tangible personal property it may qualify as section 38 property irrespective of whether it is used as an integral part of an activity (or constitutes a research or storage facility used in connection with such activity) specified in paragraph (a) of this section. Local law shall not be controlling for purposes of determining whether property is or is not "tangible" or "personal". Thus, the fact that under local law property is held to be personal property or tangible property shall not be controlling. Conversely, property may be personal property for purposes of the investment credit even though under local law the property is considered to be a fixture and therefore real property. For purposes of this section, the term "tangible personal property" means any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures (including items which are structural components of such buildings or structures). Thus, buildings, swimming pools, paved parking areas, wharves and docks, bridges, and fences are not tangible personal property. Tangible personal property includes all property (other than structural components) which is contained in or attached to a building. Thus, such property as production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs, which is contained in or attached to a building constitutes tangible personal property for purposes of the credit allowed by section 38. Further, all property which is in the nature of machinery (other than structural components of a building or other inherently permanent structure) shall be considered tangible personal property even though located outside a building. Thus, for example, a gasoline pump, hydraulic car lift, or automatic vending machine, although annexed to the ground, shall be considered tangible personal property.

(d) *Other tangible property*—(1) *In general.* In addition to tangible personal property, any other tangible property (but not including a building and its structural components) used as an integral part of manufacturing, production, or extraction, or as an integral part of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services by a person engaged in a trade or business of furnishing any such service, or which constitutes a research or storage facility used in connection with any of the foregoing activities, may qualify as section 38 property.

(2) *Manufacturing, production, and extraction.* For purposes of the credit allowed by section 38, the terms ''manufacturing'', ''production'', and ''extraction'' include the construction, reconstruction, or making of property out of scrap, salvage, or junk material, as well as from new or raw material, by processing, manipulating, refining, or changing the form of an article, or by combining or assembling two or more articles, and include the cultivation of the soil, the raising of livestock, and the mining of minerals. Thus, section 38 property would include, for example, property used as an integral part of the extracting, processing, or refining of metallic and nonmetallic minerals, including oil, gas, rock, marble, or slate; the construction of roads, bridges, or housing; the processing of meat, fish or other foodstuffs; the cultivation of orchards, gardens, or nurseries; the operation of sawmills, the production of lumber, lumber products or other building materials; the fabrication or treatment of textiles, paper, leather goods, or glass; and the rebuilding, as distinguished from the mere repairing, of machinery.

(3) *Transportation and communications businesses.* Examples of transportation businesses include railroads, airlines, bus companies, shipping or trucking companies, and oil pipeline companies. Examples of communications businesses include telephone or telegraph companies and radio or television broadcasting companies.

(4) *Integral part.* In order to qualify for the credit, property (other than tangible personal property and research or storage facilities used in connection with any of the activities specified in subparagraph (1) of this paragraph) must be used as an integral part of one or more of the activities specified in subparagraph (1) of this paragraph. Property such as pavements, parking areas, inherently permanent advertising displays or inherently permanent outdoor lighting facilities, or swimming pools, although used in the operation of a business, ordinarily is not used as an integral part of any of such specified activities. Property is used as an integral part of one of the specified activities if it is used directly in the activity and is essential to the completeness of the activity. Thus, for example, in determining whether property is used as an integral part of manufacturing, all properties used by the taxpayer in acquiring or transporting raw materials or supplies to the point where the actual processing commences (such as docks, railroad tracks and bridges), or in processing raw materials into the taxpayer's final product, would be considered as property used as an integral part of manufacturing. Specific examples of property which normally would be used as an integral part of one of the specified activities are blast furnaces, oil and gas pipelines, railroad tracks and signals, telephone poles, broadcasting towers, oil derricks, and fences used to confine livestock. Property shall be considered used as an integral part of one of the specified activities if so used either by the owner of the property or by the lessee of the property.

(5) *Research or storage facilities.* (i) If property (other than a building and its structural components) constitutes a research or storage facility and if it is used in connection with an activity specified in subparagraph (1) of this paragraph, such property may qualify as section 38 property even though it is not used as an integral part of such activity. Examples of research facilities include wind tunnels and test stands. Examples of storage facilities include oil and gas storage tanks and grain storage bins. Although a research or storage facility must be used in connection with, for example, a manufacturing process, the taxpayer-owner of such facility need not be engaged in the manufacturing process.

(ii) In the case of property described in section 50, property will constitute a storage facility only if the facility is used principally for the bulk storage of fungible commodities. Bulk storage means the storage of a commodity in a large mass prior to its consumption or utilization. Thus, if a facility is used to store oranges that have been sorted and boxed, it is not used for bulk storage.

(e) *Definition of building and structural components.* (1) Generally, buildings and structural components thereof do not qualify as section 38 property. See, however, section 48(a)(1)(E) and (g), and

§ 1.48–11 (relating to investment credit for qualified rehabilitated building). The term ''building'' generally means any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, parking, display, or sales space. The term includes, for example, structures such as apartment houses, factory and office buildings, warehouses, barns, garages, railway or bus stations, and stores. Such term includes any such structure constructed by, or for, a lessee even if such structure must be removed, or ownership of such structure reverts to the lessor, at the termination of the lease. Such term does not include (i) a structure which is essentially an item of machinery or equipment, or (ii) a structure which houses property used as an integral part of an activity specified in section 48(a)(1)(B)(i) if the use of the structure is so closely related to the use of such property that the structure clearly can be expected to be replaced when the property it initially houses is replaced. Factors which indicate that a structure is closely related to the use of the property it houses include the fact that the structure is specifically designed to provide for the stress and other demands of such property and the fact that the structure could not be economically used for other purposes. Thus, the term ''building'' does not include such structures as oil and gas storage tanks, grain storage bins, silos, fractionating towers, blast furnaces, basic oxygen furnaces, coke ovens, brick kilns, and coal tipples.

(2) The term ''structural components'' includes such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings therefor such as paneling or tiling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts; plumbing and plumbing fixtures, such as sinks and bathtubs; electric wiring and lighting fixtures; chimneys; stairs, escalators, and elevators, including all components thereof; sprinkler systems; fire escapes; and other components relating to the operation or maintenance of a building. However, the term ''structural components'' does not include machinery the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs. Machinery may meet the ''sole justification'' test provided by the preceding sentence even though it incidentally provides for the comfort of employees, or serves, to an insubstantial degree, areas where such temperature or humidity requirements are not essential. For example, an air conditioning and humidification system installed in a textile plant in order to maintain the temperature or humidity within a narrow optimum range which is critical in processing particular types of yarn or cloth is not included within the term ''structural components''. For special rules with respect to an elevator or escalator, the construction, reconstruction, or erection of which is completed by the taxpayer after June 30, 1963, or which is acquired after June 30, 1963, and the original use of which commences with the taxpayer and commences after such date, see section 48(a)(1)(C) and paragraph (m) of this section.

(f) *Intangible property.* Intangible property, such as patents, copyrights, and subscription lists, does not qualify as section 38 property. The cost of intangible property, in the case of a patent or copyright, includes all costs of purchasing or producing the item patented or copyrighted. Thus, in the case of a motion picture or television film or tape, the cost of the intangible property includes manuscript and screenplay costs, the cost of wardrobe and set design, the salaries of cameramen, actors, directors, etc., and all other costs properly includible in the basis of such film or tape. In the case of a book, the cost of the intangible property includes all costs of producing the original copyrighted manuscript, including the cost of illustration, research, and clerical and stenographic help. However, if tangible depreciable property is used in the production of such intangible property, see paragraph (b)(4) of this section.

(g) *Property used outside the United States*—(1) *General rule.* (i) Except as provided in subparagraph (2) of this paragraph, the term ''section 38 property'' does not include property which is used predominantly outside the United States (as defined in section 7701(a)(9)) during the taxable year. The determination of whether property is used predominantly outside the United States during the taxable year shall be made by comparing the period of time in such year during which the property is physically located outside the United States with the period of time in such year during which the property is physically located within the United States. If the property is physically located outside the United States during more than 50 percent of the taxable year, such property shall be considered used predominantly outside the United States during that year. If property is placed in service after the first day of the taxable year, the determination of whether such property is physically located outside the United States during more than 50 percent of the taxable year shall be made with respect to the period beginning on the date on which the property is placed in service and ending on the last day of such taxable year.

(ii) Since the determination of whether a credit is allowable to the taxpayer with respect to any property may be made only with respect to the taxable year in which the property is placed in service by the taxpayer, property used predominantly outside the United States during the taxable year in which it is placed in service cannot qualify as section 38 property with respect to such taxpayer, regardless of the fact that the property is permanently returned to the United States in a later year. Furthermore, if property is used predominantly in the United States in the year in which it is placed in service by the taxpayer, and a credit under section 38 is allowed with respect to such property, but such property is thereafter in any one year used predominantly outside the United States, such property ceases to be section 38 property with respect to the taxpayer and is subject to the application of section 47.

(iii) This subparagraph applies whether property is used predominantly outside the United States by the owner of the property, or by the lessee of the property. If property is leased and if the lessor makes a valid election under §1.48–4 to treat the lessee as having purchased such property for purposes of the credit allowed by section 38, the determination of whether such property is physically located outside the United States during more than 50 percent of the taxable year shall be made with respect to the taxable year of the lessee; however, if the lessor does not make such an election, such determination shall be made with respect to the taxable year of the lessor.

(2) *Exceptions.* The provisions of subparagraph (1) of this paragraph do not apply to—

(i) Any aircraft which is registered by the Administrator of the Federal Aviation Agency, and which (*a*) is operated, whether on a scheduled or nonscheduled basis, to and from the United States, or (*b*) is placed in service by the taxpayer during a taxable year ending after March 9, 1967, and is operated under contract with the United States: *Provided,* That use of the aircraft under the contract constitutes its principal use outside the United States during the taxable year. The term ''to and from the United States'' is not intended to exclude an aircraft which makes flights from one point in a foreign country to another such point, as long as such aircraft returns to the United States with some degree of frequency;

(ii) Rolling stock, of a domestic railroad corporation subject to part I of the Interstate Commerce Act, which is used within and without the United States. For purposes of this subparagraph, the term ''rolling stock'' means locomotives, freight and passenger train cars, floating equipment, and miscellaneous transportation equipment on wheels, the expenditures for which are chargeable (or, in the case of leased property, would be chargeable) to the equipment investment accounts in the uniform system of accounts for railroad companies prescribed by the Interstate Commerce Commission;

(iii) Any vessel documented under the laws of the United States which is operated in the foreign or domestic commerce of the United States. A vessel is documented under the laws of the United States if it is registered, enrolled, or licensed under the laws of the United States by the Commandant, U.S. Coast Guard. Vessels operated in the foreign or domestic commerce of the United States include those documented for use in foreign trade, coastwise trade, or fisheries;

(iv) Any motor vehicle of a United States person (as defined in section 7701(a)(30)) which is operated to and from the United States with some degree of frequency;

(v) Any container of a United States person which is used in the transportation of property to and from the United States;

(vi) Any property (other than a vessel or an aircraft) of a U.S. person which is used for the purpose of exploring for, developing, removing, or transporting resources from the outer Continental Shelf (within the meaning of section 2 of the Outer Continental Shelf Lands Act, as amended and supplemented; 43 U.S.C. 1331). Thus for example, offshore drilling equipment may be section 38 property;

(vii) Any property placed in service after December 31, 1965 which (*a*) is owned by a domestic corporation (other than a corporation entitled to the benefits of section 931 or 934(b)) or by a United States citizen (other than a citizen entitled to the benefits of section 931, 932, 933, or 934(c)), and (*b*) is used predominantly in a possession of the United States during the taxable year by such a corporation or such a citizen, or by a corporation created or organized in, or under the law of, a possession of the United States. Thus, property placed in service after December 31, 1965, which is owned by a domestic corporation not entitled to the benefits of section 931 or 934(b), which is leased to a corporation organized under the laws of a U.S. possession, and which is used by such lessee predominantly in a possession of the United States may qualify as section 38 property. However, property which is owned by a corporation not entitled to the benefits of section 931 or 934(b) but which is leased to a domestic corporation entitled to such benefits would not qualify as section 38 property. The determination of whether property is used predominantly in a possession of the United States during the taxable year shall be made under principles similar to those described in subparagraph (1) of this paragraph. For example, if a machine is placed in service in a possession of the United States on July 1, 1966, by a calendar year taxpayer and if it is physically located in such a possession during more than 50 percent of the period beginning on July 1, 1966 and ending on December 31, 1966, then such machine shall be considered used predominantly in a possession of the United States during the taxable year 1966;

(viii) Any communications satellite (as defined in section 103(3) of the Communications Satellite Act of 1962, 47 U.S.C., sec. 702(3)), or any interest therein, of a U.S. person;

(ix) Any cable which is property described in section 50, or any interest therein, of a domestic corporation engaged in furnishing telephone service to which section 46(c)(3)(B)(iii) applies (or of a wholly owned domestic subsidiary of such corporation), if such cable is part of a submarine cable system which constitutes part of a communications link exclusively between the United States and one or more foreign countries; and

(x) Any property described in section 50 (other than a vessel or an aircraft) of a U.S. person which is used in international or territorial waters for the purpose of exploring for, developing, removing, or transporting resources from ocean waters or deposits under such waters.

(h) *Property used for lodging*—(1) *In general.* (i) Except as provided in subparagraph (2) of this paragraph, the term ''section 38 property'' does not include property which is used predominantly to furnish lodging or is used predominantly in connection with the furnishing of lodging during the taxable year. Property used in the living quarters of a lodging facility, including beds and other furniture, refrigerators, ranges, and other equipment, shall be considered as used predominantly to furnish lodging. The term ''lodging facility'' includes an apartment house, hotel, motel, dormitory, or any other facility (or part of a facility) where sleeping accommodations are provided and let, except that such term does not include a facility used primarily as a means of transportation (such as an aircraft, vessel, or a railroad car) or used primarily to provide medical or convalescent services, even though sleeping accommodations are provided.

(ii) Property which is used predominantly in the operation of a lodging facility or in serving tenants shall be considered used in connection with the furnishing of lodging, whether furnished by the owner of the lodging facility or another person. Thus, for example, lobby furniture, office equipment, and laundry and swimming pool facilities used in the operation of an apartment house or in serving tenants would be considered used predominantly in connection with the furnishing of lodging. However, property which is used in furnishing, to the management of a lodging facility or its tenants, electrical energy, water, sewage disposal services, gas, telephone service, or other similar services shall not be treated as property used in connection with the furnishing of lodging. Thus, such items as gas and electric meters, telephone poles and lines, telephone station and switchboard equipment, and water and gas mains, furnished by a public utility would not be considered as property used in connection with the furnishing of lodging.

(iii) Notwithstanding any other provision of this paragraph (h), in the case of a qualified rehabilitated building (within the meaning of section 48(g)(1) and §1.48–12(b)), expenditures for property resulting in basis described in section 48(a)(1)(E) shall not be treated as section 38 property to the extent that such property is attributable to a portion of the building that is used for lodging or in connection with lodging. For example, if expenditures are incurred to rehabilitate a five story qualified rehabilitated building, three floors of which are used for apartments and two floors of which are used as commercial office space, the portion of the basis of the building attributable to qualified rehabilitated expenditures attributable to the commercial part of the building shall not be considered to be expenditures for property, or in connection with property, used predominantly for lodging. Allocation of expenditures between the two portions of the building are to be made using the principles contained in §1.48–12(C)(10)(ii).

(2) *Exceptions*—(i) *Nonlodging commercial facility*. A nonlodging commercial facility which is available to persons not using the lodging facility on the same basis as it is available to the tenants of the lodging facility shall not be treated as property which is used predominantly to furnish lodging or predominantly in connection with the furnishing of lodging. Examples of nonlodging commercial facilities include restaurants, drug stores, grocery stores, and vending machines located in a lodging facility.

(ii) *Property used by a hotel or motel*. Property used by a hotel, motel, inn, or other similar establishment, in connection with the trade or business of furnishing lodging shall not be considered as property which is used predominantly to furnish lodging or predominantly in connection with the furnishing of lodging, provided that the predominant portion of the living accommodations in the hotel, motel, etc., is used by transients during the taxable year. For purposes of the preceding sentence, the term ''predominant portion'' means ''more than one-half''. Thus, if more than one-half of the living quarters of a hotel, motel, inn, or other similar establishment is used during the taxable year to accommodate tenants on a transient basis, none of the property used by such hotel, motel, etc., in the trade or business of furnishing lodging shall be considered as property which is used predominantly to furnish lodging or predominantly in connection with the furnishing of lodging. Accommodations shall be considered used on a transient basis if the rental period is normally less than 30 days.

(iii) *Coin-operated machines*. In the case of property which is described in section 50, coin-operated vending machines and coin-operated washing machines and dryers shall not be considered as property which is used predominantly to furnish lodging or predominantly in connection with the furnishing of lodging.

(iv) *Certified historic structures.* For purposes of this paragraph (h), regardless of the actual use of a certified historic structure, that portion of the basis of such certified historic structure which is attributable to qualified rehabilitation expenditures (as defined in §1.48–12(c)) shall not be considered as property which is either used predominantly to furnish lodging or predominantly in connection with the furnishing of lodging. Accordingly, such portion of the basis may qualify as section 38 property. (For the definition of ''certified historic structure,'' see section 48(g)(3) and §1.48–12(d).)

(i) [Reserved]

(j) *Property used by certain tax-exempt organizations.* The term ''section 38 property'' does not include property used by an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by chapter 1 of the Code unless such property is used predominantly in an unrelated trade or business the income of which is subject to tax under section 511. If such property is debt-financed property as defined in section 514(b), the basis or cost of such property for purposes of computing qualified investment under section 46(c) shall include only that percentage of the basis or cost which is the same percentage as is used under section 514(a), for the year the property is placed in service, in computing the amount of gross income to be taken into account during such taxable year with respect to such property. The term ''property used by an organization'' means (1) property owned by the organization (whether or not leased to another person), and (2) property leased to the organization. Thus, for example, a data processing or copying machine which is leased to an organization exempt from tax would be considered as property used by such organization. Property (unless used predominantly in an unrelated trade or business) leased by another person to an organization exempt from tax or leased by such an organization to another person is not section 38 property to either the lessor or the lessee, and in either case the lessor may not elect under §1.48–4 to treat the lessee of such property as having purchased such property for purposes of the credit allowed by section 38. This paragraph shall not apply to property leased on a casual or short-term basis to an organization exempt from tax.

(k) *Property used by governmental units.* The term ''section 38 property'' does not include property used by the United States, any State (including the District of Columbia) or political subdivision thereof, any international organization (as defined in section 7701(a)(18)) other than the International Telecommunications Satellite Consortium or any successor organization, or any agency or instrumentality of the United States, of any State or political subdivision thereof, or of any such international organization. The term ''property used by the United States, etc.'' means (1) property owned by any such governmental unit (whether or not leased to another person), and (2) property leased to any such governmental unit. Thus, for example, a data processing or copying machine which is leased to any such governmental unit would be considered as property used by such governmental unit. Property leased by another person to any such governmental unit or leased by such governmental unit to another person is not section 38 property to either the lessor or the lessee, and in either case the lessor may not elect under §1.48–4 to treat the lessee of such property as having purchased such property for purposes of the credit allowed by section 38. This paragraph shall not apply to property leased on a casual or short-term basis to any such governmental unit.

(l) [Reserved]

(m) *Elevators and escalators*—(1) *In general.* Under section 48(a)(1)(C), an elevator or escalator qualifies as section 38 property if—

(i) The construction, reconstruction, or erection of the elevator or escalator is completed by the taxpayer after June 30, 1963, or

(ii) The elevator or escalator is acquired after June 30, 1963, and the original use of such elevator or escalator commences with the taxpayer and commences after such date.

In the case of construction, reconstruction, or erection of an elevator or escalator commenced before January 1, 1962, and completed after June 30, 1963, there shall be taken into account in determining the qualified investment under section 46(c) only that portion of the basis which is properly attributable to construction, reconstruction, or erection after December 31, 1961. Further, if the construction, reconstruction, or erection of such property is commenced after December 31, 1961, and is completed after June 30, 1963, the entire basis of the elevator or escalator shall be taken into account in determining qualified investment under section 46(c). Also, if an elevator or escalator is reconstructed by the taxpayer after June 30, 1963, the basis attributable to such reconstruction may be taken into account in determining the qualified investment under section 46(c), irrespective of the fact that the original construction or erection of such elevator or escalator may have occurred before January 1, 1962. Paragraph (b) of §1.48–2 shall be applied in determining the date of acquisition, original use, and basis attributable to construction, reconstruction, or erection.

(2) *Definition of elevators and escalators.* For purposes of this section the term ''elevator'' means a cage or platform and its hoisting machinery for conveying persons or freight to or from different levels and functionally related equipment which is essential to its operation. The term includes, for example, guide rails and cables, motors and controllers, control panels and landing buttons, and elevator gates and doors, which are essential to the operation of the elevator. The term ''elevator'' does not, however, include a structure which is considered a building for purposes of the investment credit. The term ''escalator'' means a moving staircase and functionally related equipment which is essential to its operation. For purposes of determining qualified investment under section 46(c) and §1.46–3, the basis of an elevator or escalator does not include the cost of any structural alterations to the building, such as the cost of constructing a shaft or of making alterations to the floor, walls, or ceiling, even though such alterations may be necessary in order to install or modernize the elevator or escalator.

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

Example 1. If an elevator with a total basis of $100,000 is completed after June 30, 1963, and the portion attributable to construction by the taxpayer after December 31, 1961, is determined by engineering estimates or by cost accounting records to be $30,000, only the $30,000 portion may be taken into account as an investment in new section 38 property in computing qualified investment.

Example 2. If construction of an elevator with a total basis of $90,000 is commenced by the taxpayer after December 31, 1961, and is completed after June 30, 1963, the entire basis of $90,000 may be taken into account as an investment in new section 38 property.

Example 3. The facts are the same as in example 2 except that construction of the elevator was completed before June 30, 1963. The elevator is not considered to be section 38 property.

Example 4. In 1964, a taxpayer reconditions an elevator, which had been constructed and placed in service in 1962 and which had an adjusted basis in 1964 of $75,000. The cost of reconditioning amounts to an additional $50,000. The basis of the elevator which may be taken into account in computing qualified investment in section 38 property is $50,000, irrespective of whether the taxpayer contracts to have it reconditioned or reconditions it himself, and irrespective of whether the materials used in the process are new in use.

(n) *Amortized property.* Any property with respect to which an election under 167(k), 169, 184, 187, or 188 applies shall not be treated as section 38 property. In the case of any property to which section 169 applies, the preceding sentence shall apply only to so much of the adjusted basis of the property as (after the application of section 169(f)) constitutes the amortizable basis for purposes of section 169. This paragraph shall not apply to property with respect to which an election under section 167(k), 184, 187, or 188 applies unless such property is described in section 50.

(o) [Reserved]

(p) *Qualified timber property.* (1) Qualified timber property (within the meaning of section 194(c)(1)) shall be treated as section 38 property to the extent of the portion of the basis of such property which is the amortizable basis (as defined in § 1.194–3(b)) acquired during the taxable year and taken into account under section 194 (after applying the limitation of section 194(b)(1)). Such amortizable basis shall qualify as section 38 property whether or not an election is made under section 194. However, any portion of such amortizable basis which is attributable to property which otherwise qualifies as section 38 property shall not be treated as section 38 property under section 48(a)(1)(F) and this paragraph. For example, amortizable basis attributable to depreciation on equipment would not qualify as section 38 property under this paragraph if such equipment qualifies as section 38 property under sections 48(a)(1) (A) or (B). In determining the portion of amortizable basis which qualifies as section 38 property under this paragraph, the reduction in amortizable basis to account for depreciation sustained with respect to property used in the reforestation process (which otherwise qualifies as section 38 property) shall be applied before the $10,000 limitation on eligible costs under section 194(b)(1). For example, if in a taxable year a taxpayer incurs qualifying reforestation costs resulting in $12,000 of amortizable basis with respect to property for which an election is in effect, and $2,000 of these costs are attributable to depreciation of the taxpayer's equipment, such $12,000 would first be reduced by the $2,000 of depreciation, and the $10,000 limitation under section 194(b)(1) would be applied following such reduction.

(2) If a taxpayer makes an election to amortize reforestation expenditures under section 194, and allocates the $10,000 limitation among more than one property under § 1.194–2(b)(2), then such allocation shall apply for purposes of determining the amortizable basis that qualifies as section 38 property under paragraph (p)(1) of this section. If no election is made under section 194, the taxpayer may select the manner in which the $10,000 limitation is to be allocated among the qualified timber properties.

(Sec. 38(b), 76 Stat. 963; 26 U.S.C. 38; secs. 194 (94 Stat. 1989; 26 U.S.C. 194) and 7805 (68A Stat. 917, 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 6731, 29 FR 6073, May 8, 1964]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.48–1, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at *www.fdsys.gov*.

§ 1.48–2 New section 38 property.

(a) *In general.* Section 48(b) defines ''new section 38 property'' as section 38 property—

(1) The construction, reconstruction, or erection of which is completed by the taxpayer after December 31, 1961, or

(2) Which is acquired by the taxpayer after December 31, 1961, provided that the original use of such property commences with the taxpayer and commences after such date.

In the case of construction, reconstruction, or erection of such property commenced before January 1, 1962, and completed after December 31, 1961, there shall be taken into account as the basis of new section 38 property in determining qualified investment only that portion of the basis which is properly attributable to contruction, reconstruction, or erection after December 31, 1961. See § 1.48–1 for the definition of section 38 property.

(b) *Special rules for determining date of acquisition, original use, and basis attributable to construction, reconstruction, or erection.* For purposes of paragraph (a) of this section, the principles set forth in paragraphs (a) (1) and (2) of § 1.167(c)–1 shall be applied. Thus, for example, the following rules are applicable:

(1) Property is considered as constructed, reconstructed, or erected by the taxpayer if the work is done for him in accordance with his specifications.

(2) The portion of the basis of property attributable to construction, reconstruction, or erection after December 31, 1961, consists of all costs of construction, reconstruction, or erection allocable to the period after December 31, 1961, including the cost or other basis of materials entering into such work (but not including, in the case of

reconstruction of property, the adjusted basis of the reconstructed property as of the time such reconstruction is commenced).

(3) It is not necessary that materials entering into construction, reconstruction, or erection be acquired after December 31, 1961, or that they be new in use.

(4) If construction or erection by the taxpayer began after December 31, 1961, the entire cost or other basis of such construction or erection may be taken into account as the basis of new section 38 property.

(5) Construction, reconstruction, or erection by the taxpayer begins when physical work is started on such construction, reconstruction, or erection.

(6) Property shall be deemed to be acquired when reduced to physical possession, or control.

(7) The term ''original use'' means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. For example, a reconditioned or rebuilt machine acquired by the taxpayer will not be treated as being put to original use by the taxpayer. The question of whether property is reconditioned or rebuilt property is a question of fact. Property will not be treated as reconditioned or rebuilt merely because it contains some used parts.

If the cost of reconstruction may properly either be capitalized and recovered through depreciation or charged against the depreciation reserve, such cost may be taken into account as the basis of new section 38 property even though it is charged against the depreciation reserve.

(c) *Examples.* This section may be illustrated by the following examples:

Example 1. If a machine with a total cost of $100,000 is completed after December 31, 1961, and the portion attributable to construction by the taxpayer after December 31, 1961, is determined by engineering estimates or by cost accounting records to be $30,000, the $30,000 amount shall be taken into account by the taxpayer in computing qualified investment in new section 38 property.

Example 2. In 1965, a taxpayer reconditions a machine, which he constructed and placed in service in 1962 and which has an adjusted basis in 1965 of $10,000. The cost of reconditioning amounts to an additional $20,000. The basis of the machine which shall be taken into account in computing qualified investment in new section 38 property for 1965 is $20,000, whether he contracts to have it reconditioned or reconditions it himself, and irrespective of whether the materials used for reconditioning are new in use.

Example 3. In 1961, a taxpayer pays the entire purchase price of $10,000 for section 38 property to be delivered in 1962. In 1962 he takes possession of the property and commences the original use of the asset in that year. The $10,000 amount shall be taken into account in computing qualified investment in new section 38 property for 1962.

Example 4. A taxpayer, instead of reconditioning his old machine, buys a ''factory reconditioned'' or ''rebuilt'' machine in 1962 to replace it. The reconditioned or rebuilt machine is not new section 38 property since such taxpayer is not the first user of the machine. See, however, §1.48–3 (relating to used section 38 property).

Example 5. In 1962, a taxpayer buys from X for $20,000 an item of section 38 property which has been previously used by X. The taxpayer in 1962 makes an expenditure on the property of $5,000 of the type that must be capitalized. Regardless of whether the $5,000 is added to the basis of such property or is capitalized in a separate account, such amount shall be taken into account by the taxpayer in computing qualified investment in new section 38 property for 1962. No part of the $20,000 purchase price may be taken into account for such purpose. See, however, §1.48–3 (relating to used section 38 property).

(d) *Special rule for qualified rehabilitated buildings.* Notwithstanding the rules in paragraphs (a) through (c) of this section, that portion of the basis of a qualified rehabilitated building attributable to qualified rehabilitation expenditures is treated as new section 38 property. See section 48(a)(1)(E) and (g), and §1.48–11.

[T.D. 6731, 29 FR 6076, May 8, 1964, as amended by T.D. 8031, 50 FR 26698, June 28, 1985]

§ 1.48–3 Used section 38 property.

(a) *In general.* (1) Section 48(c) provides that ''used section 38 property'' means section 38 property acquired by purchase after December 31, 1961, which is not ''new section 38 property.'' See §§1.48–1 and 1.48–2, respectively, for definitions of section 38 property and new section 38 property. In determining whether property is acquired by purchase, the provisions of paragraph (c)(1) of §1.179–3 shall apply, except that (i) ''1961'' shall be substituted for

"1957", and (ii) the definition of "component member" of a controlled group of corporations in paragraph (d)(4) of this section shall be substituted for the definition of such term in paragraph (e) of § 1.179–3.

(2)(i) Property shall not qualify as used section 38 property if, after its acquisition by the taxpayer, it is used by (*a*) a person who used such property before such acquisition, or (*b*) a person who bears a relationship described in section 179(d)(2) (A) or (B) to a person who used such property before such acquisition. Thus, for example, if property is used by a person and is later sold by him under a sale and lease-back arrangement, such property in the hands of the purchaser-lessor is not used section 38 property because the property, after its acquisition, is being used by the same person who used it before its acquisition. Similarly, where a lessee has been leasing property and subsequently purchases it (whether or not the lease contains an option to purchase), such property is not used section 38 property with respect to the purchaser because the property is being used by the same person who used it before its acquisition. In addition, if property owned by a lessor is sold subject to the lease, or is sold upon the termination of the lease, the property will not qualify as used section 38 property with respect to the purchaser if, after the purchase, the property is used by a person who used the property as a lessee before the purchase.

(ii) For purposes of applying subdivision (i) of this subparagraph, property shall not be considered as used by a person before its acquisition if such property was used only on a casual basis by such person.

(iii) In determining whether a person bears a relationship described in section 179(d)(2) (A) or (B) to a person who used property before its acquisition by the taxpayer, the provisions of paragraphs (c)(1) (i) and (ii) of § 1.179–3 shall apply, except that the definition of "component member" of a controlled group of corporations in paragraph (d)(4) of this section shall be substituted for the definition of such term in paragraph (e) of § 1.179–3.

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

Example 1. Corporation P acquires properties 1 and 2 in 1960 and uses them in its trade or business until 1962. In 1962, corporation P sells such properties to corporation Y, which leases back property 1 to corporation P and leases property 2 to corporation S, a wholly owned subsidiary of corporation P. Property 1 is not used section 38 property in the hands of corporation Y because, after its acquisition by corporation Y, it is used by a person (corporation P) who used it prior to such acquisition. Property 2 is not used section 38 property because, after its acquisition by corporation Y, it is used by a person (corporation S) who is related, within the meaning of section 179(d)(2)(B), to a person (corporation P) who used it before such acquisition.

Example 2. In 1962, corporation L leases property from corporation M. In 1964, corporation L acquires the property that it previously had been leasing. The property acquired by corporation L is not used section 38 property because such property is used after such acquisition by the same person (corporation L) who used the property before its acquisition (corporation L).

Example 3. Corporation X buys property in 1962 and leases such property to corporation Y. Corporation X in 1965 sells the property to A subject to the lease. The property acquired by A is not used section 38 property if such property continues to be used by corporation Y, because corporation Y used the property before its acquisition by A.

Example 4. A owns a bulldozer which he rents out to a number of different users, including B. In 1962, B used the bulldozer from February 16 to March 12 and again on October 15 and 16. B purchases the bulldozer from A on December 1, 1962. The prior use of the property by B does not disqualify such property as used section 38 property to B, because he used such property only on a casual basis prior to its purchase.

(b) *Cost.* (1) The cost of used section 38 property is equal to the basis of such property, but does not include so much of such basis as is determined by reference to the adjusted basis of other property (whether or not section 38 property) held at any time by the taxpayer acquiring such used section 38 property.

(2) If property (whether or not section 38 property) is disposed of by the taxpayer (other than by reason of its destruction or damage by fire, storm, shipwreck, or other casualty, or its theft) and used section 38 property

similar or related in service or use is acquired as a replacement therefor in a transaction in which the basis of the replacement property is not determined by reference to the adjusted basis of the property replaced, then the cost of the used section 38 property so acquired shall be its basis reduced by the adjusted basis of the property replaced. The preceding sentence shall apply only if the taxpayer acquires (or enters into a contract to acquire) the replacement property within a period of 60 days before or after the date of the disposition.

(3) Notwithstanding subparagraphs (1) and (2) of this paragraph, the cost of used section 38 property shall not be reduced with respect to the adjusted basis of any property disposed of if, by reason of section 47, such disposition resulted in an increase of tax or a reduction of investment credit carrybacks or carryovers described in section 46(b).

(4) The provisions of this paragraph may be illustrated by the following examples:

Example 1. In 1972, A acquires machine 2 (an item of used section 38 property which has a sales price of $5,600) by trading in machine 1 (an item of section 38 property acquired in 1962), and by paying an additional $4,000 cash. The adjusted basis of machine 1 is $1,600. Under the provisions of sections 1012 and 1031(d), the basis of machine 2 is $5,600 ($1,600 adjusted basis of machine 1 plus cash expended of $4,000). The cost of machine 2 which may be taken into account in computing qualified investment for 1972 is $4,000 (basis of $5,600 less $1,600 adjusted basis of machine 1).

Example 2. The facts are the same as in example 1 except that machine 2 has a sales price of $6,000. The trade-in allowance on machine 1 is $2,000. The result is the same as in example 1, that is, the basis of machine 2 is $5,600 ($1,600 plus $4,000); therefore, the cost of machine 2 which may be taken into account in computing qualified investment for 1972 is $4,000 (basis of $5,600 less $1,600 adjusted basis of machine 1).

Example 3. On September 18, 1962, B sells truck 1, which he acquired in 1961 and which has an adjusted basis in his hands of $1,200. On October 15, 1962, he purchases for $2,000 truck 2 (an item of used section 38 property) as a replacement therefor. The cost of truck 2 which may be taken into account in computing qualified investment is $800 ($2,000 less $1,200).

Example 4. In 1962, C acquires property 1, an item of new section 38 property with a basis of $12,000 and a useful life of eight years or more. He is allowed a credit under section 38 of $840 (7 percent of $12,000) with respect to such property. In 1968, C acquires property 2 (an item of used section 38 property) by trading in property 1 and by paying an additional amount in cash. Section 47(a) applies to the disposition of property 1 and C's tax liability for 1968 is increased by $280. Since the application of section 47(a) results in an increase in tax, for purposes of computing qualified investment the cost of property 2 is not reduced by any part of the adjusted basis of the property traded in.

(c) *Dollar limitation*—(1) *In general.* Section 48(c)(2) provides that the aggregate cost of used section 38 property which may be taken into account for any taxable year in computing qualified investment under section 46(c)(1)(B) shall not exceed $50,000. If the total cost of used section 38 property exceeds $50,000, there must be selected, in the manner provided in subparagraph (4) of this paragraph, the particular items of used section 38 property the cost of which is to be taken into account in computing qualified investment. The cost of used section 38 property that may be taken into account by a person in applying the $50,000 limitation for any taxable year includes not only the cost of used section 38 property placed in service by such person during such taxable year, but also the cost of used section 38 property apportioned to such person. For purposes of this section, the cost of used section 38 property apportioned to any person means the cost of such property apportioned to him by a trust, estate, or electing small business corporation (as defined in section 1371(b)), and his share of the cost of partnership used section 38 property, with respect to the taxable year of such trust, estate, corporation or partnership ending with or within such person's taxable year. Thus, if an individual places in service during his taxable year used section 38 property with a cost of $25,000, if the cost of used section 38 property apportioned to him by an electing small business corporation for such year is $30,000, and if his share for such year of the cost of used section 38 property placed in service by a partnership is $20,000, he may select from the used section 38 property with a total cost of $75,000 the particular used section 38 property the cost of which he wishes to take into account. No part of the excess of $25,000 ($75,000 cost minus $50,000 annual limitation) may be taken into account in any other taxable year. For determining the amount of the cost to be apportioned by an electing small business corporation, see paragraph (a)(2) of §1.48–5; in the case of estates and trusts, see paragraph (a)(2) of §1.48–6. See paragraph (e) of this section for application of $50,000 limitation in the case of affiliated groups.

(2) *Married individuals filing separate returns.* In the case of a husband or wife who files a separate return, the aggregate cost of used section 38 property which may be taken into account for the taxable year to which such return relates cannot exceed $25,000. The preceding sentence shall not apply, however, unless the taxpayer's spouse places in service (or is apportioned the cost of) used section 38 property for the taxable year of such spouse which ends with or within the taxpayer's taxable year. Thus, if a husband and wife who file separate returns on a calendar year basis both place in service used section 38 property during the taxable year, the maximum cost of used section 38 property which may be taken into account by each is $25,000. However, in such case, if only one spouse places in service (or is apportioned the cost of) used section 38 property during the taxable year, such spouse may take into account a maximum of $50,000 for such year. The determination of whether an individual is married shall be made under the principles of section 143 and the regulations thereunder.

(3) *Partnerships.* In the case of a partnership, the aggregate cost of used section 38 property placed in service by the partnership (or apportioned to the partnership) which may be taken into account by the partners with respect to any taxable year of the partnership may not exceed $50,000. If such aggregate cost exceeds $50,000, the partnership must make a selection in the manner provided in subparagraph (4) of this paragraph. The $50,000 limitation applies to each partner, as well as to the partnership.

(4) *Selection of $50,000 cost.* (i) If the sum of (*a*) the cost of used section 38 property placed in service during the taxable year by any person, (*b*) such person's share of the cost of partnership used section 38 property placed in service during the taxable year of a partnership ending with or within such person's taxable year, and (*c*) the cost of used section 38 property apportioned to such person for such taxable year by an electing small business corporation, estate, or trust, exceeds $50,000, such person must make a selection for such taxable year in the manner provided in subdivision (ii) of this subparagraph.

(ii) For purposes of computing qualified investment (or, in the case of a partnership, electing small business corporation, estate, or trust, for purposes of selecting used section 38 property the cost of which may be taken into account by the partners, shareholders, or estate or trust and its beneficiaries) any person to whom subdivision (i) of this subparagraph applies must select a total cost of $50,000 from (*a*) the cost of specific used section 38 property placed in service by such person, (*b*) such person's share of the cost of specific used section 38 property placed in service by a partnership and (*c*) the cost of used section 38 property apportioned to such person by an electing small business corporation, estate, or trust. When a particular property is selected, the entire cost (or entire share of cost of a particular property in the case of partnership property) of such property must be taken into account unless, as a result of the selection of such particular property, the $50,000 limitation is exceeded. Likewise, in the case of an apportionment from an electing small business corporation, estate, or trust, when the cost in a particular useful life category is selected, the entire cost in such category must be taken into account unless, as a result of the selection of such cost, the $50,000 limitation is exceeded. Thus, if a person places in service during the taxable year three items of used section 38 property, each with a cost of $20,000, he must select the entire cost of two of the items and only $10,000 of the cost of the third item; he may not select a portion of the cost of each of the three items. The selection by any person shall be made by taking the cost of used section 38 property into account in computing qualified investment (or in selecting the used section 38 property the cost of which may be taken into account by the partners, etc.), and if such property was placed in service by such person, he must maintain records which permit specific identification of any item of used section 38 property selected.

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

Example 1. H, who operates a sole proprietorship, purchases and places in service in 1963 used section 38 property with a cost of $60,000. His spouse, W, is a shareholder in an electing small business corporation which purchases and places in service during its fiscal year ending June 30, 1963, used section 38 property with a cost of $50,000. Both spouses file separate returns on a calendar year basis. W, as a 60 percent shareholder on the last day of the taxable year of the corporation, is apportioned $30,000 (60 percent of $50,000) of the cost of the used section 38 property placed in service by the corporation. The cost of used section 38 property that may be taken into account by H on his separate return is $25,000. The cost of used section 38 property that may be taken into account by W on her separate return is $25,000. On the other hand, if the corporation had made no investment in used section 38 property, H could take $50,000 of the $60,000 cost into account.

Example 2. Partners X, Y, and Z share the profits and losses of partnership XYZ in the ratio of 50 percent, 30 percent, and 20 percent, respectively. The partnership and each partner make returns on the basis of the calendar year. Each partner also operates a sole proprietorship. In 1963, the partnership and the partners purchase and place in service the following used section 38 property:

Property	Estimated useful life (years)	Cost
Partnership XYZ		
Property No. 1	9	$10,000
Property No. 2	7	50,000
Property No. 3	7	50,000
Property No. 4	5	30,000
Partner X		
Property No. 5	6	30,000
Partner Y		
Property No. 6	10	60,000
Partner Z		
Property No. 7	4	36,000

(i) *Selection by partnership*. In accordance with subparagraph (4)(ii) of this paragraph, the partnership selects property No. 1 and $40,000 of the cost of property No. 2 to be taken into account. Therefore, each partner's share of cost of the property selected by the partnership is as follows:

Property No.	Estimated useful life (years)	Selected cost	Partner's share of cost		
			X (50%)	Y (30%)	Z (20%)
1	9	$10,000	$5,000	$3,000	$2,000
2	7	40,000	20,000	12,000	8,000
Total		50,000	25,000	15,000	10,000

(ii) *Selection by partners*. In accordance with subparagraph (4)(ii) of this paragraph, the partners make the following selections: Partner X selects property No. 5 ($30,000), his share of the cost of property No. 1 ($5,000), and $15,000 of his share of the cost of property No. 2. Partner Y selects $50,000 of the cost of property No. 6, and no part of his share of the cost of partnership property. Partner Z, having an aggregate cost of used section 38 property of only $46,000 (partnership property of $10,000 and individually owned property of $36,000), takes into account the entire $46,000.

(iii) *Qualified investment of partner X*. X's total qualified investment in used section 38 property for 1963 is $35,000, computed as follows:

Property No.	Estimated useful life (years)	Selected cost	Applicable percentage	Qualified investment
1	9	$5,000	100	$5,000
2	7	15,000	66⅔	10,000
5	6	30,000	66⅔	20,000
Total		50,000		35,000

(iv) *Qualified investment of partner Y.* Y's total qualified investment in used section 38 property for 1963 is $50,000 (100 percent of $50,000) since he selected $50,000 of the cost of property No. 6 which has a useful life of 8 years or more.

(v) *Qualified investment of partner Z.* Z's total qualified investment in used section 38 property for 1963 is $19,333, computed as follows:

Property No.	Estimated useful life (years)	Selected cost	Applicable percentage	Qualified investment
1	9	$2,000	100	$2,000
2	7	8,000	66⅔	5,333
7	4	36,000	33⅓	12,000
Total		46,000		19,333

(d) *Dollar limitation for component members of a controlled group*—(1) *In general.* (i) Section 48(c)(2)(C) provides that the $50,000 limitation on the cost of used section 38 property which may be taken into account for any taxable year shall, in the case of component members of a controlled group (as defined in subparagraph (4) of this paragraph) on a particular December 31, be reduced for each such member by apportioning the $50,000 amount among such component members for their taxable years that include such December 31 in accordance with their respective amounts of used section 38 property which may be taken into account, that is, in accordance with the total cost of used section 38 property placed in service by each such member during its taxable year (without regard to the $50,000 limitation or the applicable percentages to be applied in computing qualified investment).

(ii) Except as otherwise provided in this paragraph, the $50,000 amount shall be apportioned among those corporations which are component members of the controlled group on a December 31. For the taxable year of each such member which includes such December 31, the cost of used section 38 property taken into account in computing qualified investment under section 46(c)(1)(B) shall not exceed the amount which bears the same ratio to $50,000 as the cost of used section 38 property placed in service by such member for such taxable year bears to the total cost of used section 38 property placed in service by all component members of the controlled group for their taxable years which include such December 31.

(iii) If a component member of the group makes its income tax return on the basis of a 52–53-week taxable year, the principles of section 441(f)(2)(A)(ii) and §1.441–2 apply in determining the last day of such a taxable year.

(2) *Statement by the ''filing member''.* For purposes of this paragraph, the term ''filing member'' with respect to a particular December 31 means the member (or members) of a controlled group which has, among those members of the group which are apportioned part of the $50,000 amount for their taxable years which include such December 31, the taxable year including such December 31 which ends on the earliest date. The filing member of the group shall attach to its income tax return a statement containing the name, address, and employer identification number of each component member of the controlled group on such December 31 and a schedule showing the computation of the apportionment of the $50,000 amount among the component members of the group. Each such other member shall retain as part of its records a copy of the statement containing the apportionment schedule. Except as otherwise provided in subparagraph (3)(ii) of this paragraph, each member which is apportioned part of the $50,000 amount shall take such apportioned amount into account in filing its return for its taxable year which includes such December 31.

(3) *Estimate of used section 38 property to be placed in service.* (i) For purposes of subparagraphs (1) and (2) of this paragraph, if on the date (including extensions of time) for filing the income tax return of the filing member of the

group with respect to a particular December 31, the total cost of used section 38 property actually placed in service by any component member of the group during such member's taxable year that includes such December 31 is not known, then such member shall estimate such cost. The estimate shall be made on the basis of the facts and circumstances known as of the time of the estimate. Any such estimate shall also be used in determining the total cost of used section 38 property placed in service by all component members for their taxable years including such December 31.

(ii) If an estimate is used by any component member of a controlled group pursuant to subdivision (i) of this subparagraph, each member may later file an original or amended return in which the apportionment of the $50,000 amount is based upon the cost of used section 38 property actually placed in service by all component members of the group during their taxable year which include such December 31. Such amended apportionment shall be made only if each component member of the group whose limitation would be changed files an original or amended return which reflects the amended apportionment based upon the cost of the used section 38 property actually placed in service by component members of the group. In such case, the new statement reflecting the amended apportionment shall be attached to the amended return of the filing member of the group, and a copy of such statement shall be retained by each such member pursuant to the requirements of subparagraph (2) of this paragraph.

(4) *Definitions of controlled group of corporations and component member of controlled group.* For purposes of this section, the terms ''controlled group of corporations'' and ''component member'' of a controlled group of corporations shall have the same meaning assigned to those terms in section 1563 (a) and (b), except that the phrase ''more than 50 percent'' shall be substituted for the phrase ''at least 80 percent'' each place it appears in section 1563(a)(1). For purposes of applying §1.1563–1(b)(2)(ii)(*c*), an electing small business corporation shall be treated as an excluded member whether or not it is subject to the tax imposed by section 1378.

(5) *Members of controlled group filing a consolidated return.* For the purpose of apportioning the $50,000 amount in the case of component members of a controlled group which join in filing a consolidated return, all such members shall be treated as though they were a single component member of the controlled group. Thus, in determining the limitation on the cost of used section 38 property which may be taken into account by the group filing the consolidated return, the apportionment provided in subparagraph (1)(ii) of this paragraph shall be made by using the aggregate cost of such property placed in service by all members of the group filing the consolidated return. If all component members of the controlled group join in filing a consolidated return, the group may select the items to be taken into account to the extent of an aggregate cost of $50,000; if some component members of the controlled group do not join in filing the consolidated return, then the members of the group which join in filing the consolidated return may select the items to be taken into account to the extent of the amount apportioned to such members under subparagraph (1)(ii) of this paragraph.

(6) *Examples.* This paragraph may be illustrated by the following examples:

Example 1. (i) On December 31, 1970, corporations M, N, and O are component members of the same controlled group. The taxable years of M, N, and O end, respectively, on January 31, March 31, and April 30. During the respective taxable years of each corporation which include December 31, 1970, M places in service no used section 38 property, and N and O place in service used section 38 property with respective costs of $100,000 and $150,000. N is the ''filing member'' of the group since N, among the members (N and O) which are apportioned part of the $50,000 amount for their taxable years which include such December 31, has the taxable year ending on the earliest date.

(ii) The cost of used section 38 property taken into account by N for its taxable year ending March 31, 1971, may not exceed $20,000, that is, an amount which bears the same ratio to $50,000 as the cost of used section 38 property placed in service by N for its taxable year ($100,000) bears to the total cost of used section 38 property placed in service by all component members of the controlled group (M, N, and O) for their taxable years which include December 31, 1970 ($250,000). Similarly, the cost of used section 38 property taken into account by O for its taxable year ending April 30, 1971, may not exceed $30,000.

Example 2. (i) On December 31, 1971, corporations S and T are component members of the same controlled group. The taxable years of corporations S and T end, respectively, on January 31 and June 30. On April 15, 1972, S files an income tax return for its taxable year ending January 31, 1972, during which year it places in service used section 38 property costing $100,000. T estimates that it will place in service used section 38 property costing $150,000 during its taxable year ending June 30, 1972.

(ii) S, the ''filing member'' of the group, must file an apportionment schedule under which it may take into account as the cost of used section 38 property an amount not in excess of $20,000 ($100,000/$250,000 × $50,000). If T actually places in service during its taxable year used section 38 property costing more or less than $150,000, its income tax return for its taxable year ending June 30, 1972, may reflect the amended apportionment of the $50,000 limitation based upon the cost of used section 38 property actually placed in service by the group, provided that S attaches a new apportionment schedule to an amended return to reflect the amended apportionment. For example, if T places in service used section 38 property costing $200,000, the cost of used section 38 property taken into account by S and T for their respective taxable years could not exceed $16,667 ($100,000/$300,000 × $50,000) and $33,333 ($200,000/$300,000 × $50,000), respectively, under an amended apportionment.

(Secs. 38(b) and 7805 of the Internal Revenue Code of 1954 (76 Stat. 962, U.S.C. 38(b); 68A Stat. 917; 26 U.S.C. 7805)

[T.D. 6731, 29 FR 6076, May 8, 1964, as amended by T.D. 7181, 37 FR 8064, Apr. 25, 1972; T.D. 7820, 47 FR 25139, June 10, 1982; T.D. 8996, 67 FR 35012, May 17, 2002]

§ 1.48–4 Election of lessor of new section 38 property to treat lessee as purchaser.

(a) *In general*—(1) *Lessee treated as purchaser*. Under section 48(d), a lessor of property may elect to treat the lessee of such property as having purchased such property (or, in the case of short-term lease property described in subparagraph (2) of this paragraph, a portion of such property) for purposes of the credit allowed by section 38 if the following conditions are satisfied:

(i) The property must be ''section 38 property'' in the hands of the lessor; that is, it must be property with respect to which depreciation (or amortization in lieu of depreciation) is allowable to the lessor, it must have a useful life of 3 years (4 years in the case of property which is not described in section 50) or more in his hands, and in every other respect it must meet the requirements of § 1.48–1. Thus, for example, property leased by a municipality to a taxpayer for use in what is commonly known as an ''industrial park'' is not eligible for the election since, under paragraph (k) of § 1.48–1, property used by a governmental unit is not section 38 property. In addition, property used by the lessee predominantly outside the United States is not eligible for the election since, under paragraph (g) of § 1.48–1, such property is not section 38 property. For purposes of this subdivision, if the lessor is an estate or trust, depreciation (or amortization in lieu of depreciation) will be considered allowable to the estate or trust even if it is apportioned to the beneficiaries or other persons.

(ii) The property must be ''new section 38 property'' (within the meaning of § 1.48–2) in the hands of the lessor, and the original use of such property must commence with the lessor. See paragraph (b) of this section for the application of the rules relating to ''original use'' in the case of leased property.

(iii) The property would constitute ''new section 38 property'' to the lessee if such lessee had actually purchased the property. Thus, the election is not available if the lessee is not the original user of the property. See paragraph (b) of this section for the application of the rules relating to ''original use'' in the case of leased property. See paragraph (d) of this section for the determination of the estimated useful life of leased property in the hands of the lessee.

(iv) A statement of election to treat the lessee as a purchaser has been filed in the manner and within the time provided in paragraph (f) or (g) of this section.

(v) The lessor is not a person referred to in section 46(d)(1), that is, a mutual savings bank, cooperative bank, or domestic building and loan association to which section 593 applies; a regulated investment company or real estate investment trust subject to taxation under subchapter M, chapter 1 of the Code; or a cooperative organization described in section 1381(a).

The election may be made on a property-by-property basis or a general election may be made with respect to each taxable year of a particular lessee. If the conditions of this subparagraph have been met, the lessee shall be treated as though he were the actual owner of all or a portion of the property for purposes of the credit allowed by section 38. Thus, the lessee shall be entitled to a credit allowed by section 38 with respect to such property for the taxable year in which he places such property in service, and the lessor shall not be entitled to a credit allowed by section 38 with respect to such property unless the property is short-term lease property (as defined in subparagraph (2) of this paragraph). Moreover, if the leased property is disposed of, or if it otherwise ceases to be section 38 property, the property will be subject to the provisions of section 47 (relating to early dispositions, etc.).

(2) *Short-term lease property*. For purposes of this section, the term ''short-term lease property'' means property which—

(i) Is new section 38 property;

(ii) Has a class life (determined under section 167(m)) in excess of 14 years;

(iii) Is leased under a lease entered into after November 8, 1971, for a period which is less than 80 percent of the class life of such property; and

(iv) Is not leased subject to a net lease within the meaning of section 57(c)(1)(B) and the regulations thereunder.

The class life of property shall be determined under section 167(m) and the regulations prescribed in connection with that section, except that such class life shall be determined without regard to any variance from the class life permitted under such section. If a class life has not been prescribed for property under section 167(m) on the date such property is leased, the class life of the property shall be the estimated useful life used to compute the allowance for depreciation with respect to such property under section 167. For purposes of subdivision (iii) of this subparagraph, the period for which a lease is entered into shall be determined without regard to any option on the part of the lessee to extend or renew such lease, and without regard to any option on the part of the lessee to cancel the lease after a specified period if under the terms of such lease, such a cancellation would result in the imposition of a substantial penalty upon the lessee. Generally, a penalty equal to 25 percent of the total remaining rental payments due under the lease will be regarded as substantial.

(b) *Original use*. For purposes of this section only, the lessor and the lessee may both be considered as the original users of an item of leased property. The determination of whether the lessor qualifies as the original user of leased property shall be made under paragraph (b)(7) of §1.48–2. The determination of whether the lessee qualifies as the original user of leased property shall be made, under paragraph (b)(7) of §1.48–2, as if the lessee actually purchased the property. Thus, the lessee would not be considered the original user of the property if it has been previously used by the lessor or another person, or if it is reconstructed, rebuilt, or reconditioned property. However, the lessee would be considered the original user if he is the first person to use the property for its intended function. Thus, the fact that the lessor may have, for example, tested, stored, or attempted to lease the property to other persons will not preclude the lessee from being considered the original user.

(c) *Qualified investment*—(1) *In general*. If a valid election is made under this section, the amount of qualified investment under section 46(c) with respect to the leased property shall be determined under this paragraph and paragraphs (d) and (e) of this section.

(2) *Nonshort-term lease property*. In the case of property which is not short-term lease property, the lessee is treated as having acquired the entire property for an amount equal to—

(i) The fair market value of such property on the date possession is transferred to the lessee, or

(ii) If the property is leased by a component member of a controlled group to another component member of the same controlled group (within the meaning of paragraph (f)(4) of §1.46–1) on the date possession of the property is transferred to the lessee, the basis of the property in the hands of the lessor.

(3) *Short-term lease property.* (i) In the case of short-term lease property, the lessee is treated as having acquired a portion of such property. The amount for which the lessee is treated as having acquired such portion is an amount equal to a fraction, the numerator of which is the term of the lease and the denominator of which is the class life of the property leased, of the amount for which the lessee would be treated as having acquired the property under subparagraph (2) of this paragraph if the property were not short-term lease property.

(ii) In the case of short-term lease property, the qualified investment of the lessor is an amount equal to his qualified investment in such property determined under section 46(c) multiplied by a fraction, the numerator of which is the class life of the property leased minus the term of the lease and the denominator of which is the class life of such property.

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

Example. (a) On December 1, 1971, X corporation completed construction of an item of new section 38 property with a basis of $10,000. Under section 167(m), the property has a class life of 16 years. On December 1, 1971, X leases the property to individual A for 4 years and A immediately places the property in service. The lease is not a net lease within the meaning of section 57(c)(1)(B). On the date of the lease, the fair market value of the property is $12,000. The property would qualify as new section 38 property in A's hands if it had been purchased by A. Under this section, the property is short-term lease property. X makes the election under this section to treat A as having acquired a portion of the property.

(b) A is treated as having acquired from X a portion of the property for $3,000 (the fair market value of the property, $12,000, multiplied by a fraction, 4⁄16 , the numerator of which is the term of the lease and the denominator of which is the class life of the leased property). Since under paragraph (d) of this section the useful life of such property in the hands of A is the same as the useful life of such property in the hands of X, and such useful life is at least 7 years, A's qualified investment with respect to the property is $3,000.

(c) The qualified investment of X is $7,500 (the qualified investment of X under section 46(c), $10,000, multiplied by a fraction, 12⁄16, the numerator of which is the class life of the leased property, 16, minus the term of the lease, 4, and the denominator of which is the class life of the property).

(d) *Estimated useful life of leased property.* The estimated useful life to the lessee of property subject to the election shall be deemed to be the estimated useful life in the hands of the lessor for purposes of computing depreciation, regardless of the term of the lease. The lessor shall determine the estimated useful life of each leased property on an individual basis even though multiple asset accounts are used. However, in the case of assets similar in kind contained in a multiple asset account, the lessor shall assign to each of such assets the average useful life of such assets used in computing depreciation. Thus, for example, if during a taxable year a lessor leases 10 similar trucks with an average estimated useful life for depreciation purposes of 6 years, based on an estimated range of 5 to 7 years, he must assign a useful life of 6 years to each of the 10 trucks.

(e) *Lessor itself a lessee*—(1) *In general.* If the lessee of property is treated, under this section, as having purchased all or a portion of such property and if such lessee leases such property to a sublessee, the qualified investment with respect to such property in the hands of the sublessee shall be determined under paragraphs (c) and (d) of this section as if the original lessor had leased the property directly to the sublessee for the term of the sublessee's lease on the date possession of the property is transferred to the sublessee. For this purpose, property which is short-term lease property in the hands of the lessee shall be treated as short-term lease property in the hands of the sublessee regardless of whether such property is leased to the sublessee subject to a net lease (within the meaning of section 57(c)(1)(B)). In the case of property which is short-term lease property in the hands of the sublessee, the amount for which the lessee is treated as having acquired such property under paragraph (c) of this section shall be reduced by an amount equal to such amount multiplied by a fraction, the numerator of which is the term of the lease of the sublessee and the denominator of which is the term of the lease of the lessee.

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

Example. (a) On December 1, 1971, corporation X completes construction of a machine at a cost of $10,000. The machine has a class life under section 167(m) of 20 years. On December 1, 1971, X leases the machine to corporation Y for 12 years, and Y immediately subleases the machine to individual A for 8 years. X and Y are component members of the same controlled group. The lease between X and Y is not a net lease within the meaning of section 57(c)(1)(B). The fair market value of the property on December 1, 1971, is $16,000. Both X and Y make valid elections under this section.

(b) The property is short-term lease property and this paragraph applies.

(c) The qualified investment of A is $6,400. Such amount is determined by multiplying $16,000, the amount for which A would be treated under paragraph (c)(2) of this section as having acquired the property if it were not short-term lease property, by 8⁄20.

(d) The qualified investment of Y is $2,000. Such amount is determined by multiplying $10,000, the amount for which Y would be treated under paragraph (c)(2) of this section as having acquired the property if it were not short-term lease property, by 12⁄20, and by reducing the amount so determined ($6,000) by 8⁄12 of such amount ($4,000) to $2,000.

(e) The qualified investment of X is $4,000. Such amount is determined by multiplying the amount of X's qualified investment determined under section 46(c) without regard to this section ($10,000) by 8⁄20.

(f) *Property-by-property election*—(1) *Manner of making election*. The election of a lessor with respect to a particular property (or properties) shall be made by filing a statement with the lessee, signed by the lessor and including the written consent of the lessee, containing the following information:

(i) The name, address, and taxpayer account number of the lessor and the lessee;

(ii) The district director's office with which the income tax returns of the lessor and the lessee are filed;

(iii) A description of each property with respect to which the election is being made;

(iv) The date on which possession of the property (or properties) is transferred to the lessee;

(v) The estimated useful life category of the property (or properties) in the hands of the lessor, that is, 3 years or more but less than 5 years, 5 years or more but less than 7 years, or 7 years or more;

(vi) The amount for which the lessee (or sublessee) is treated as having acquired the leased property under paragraph (c)(2) or (3) of this section; and

(vii) If the lessor is itself a lessee, the name, address, and taxpayer account number of the original lessor, and the district director's office with which the income tax return of such original lessor is filed.

(2) *Time for making election*. The statement referred to in subparagraph (1) of this paragraph shall be filed with the lessee on or before the due date (including any extensions of time) of the lessee's return for the lessee's taxable year during which possession of the property is transferred to the lessee, except that if such taxable year ends after March 31, 1971, and before December 11, 1971, the statement shall be filed with the lessee on or before the due date (including any extensions of time) of the lessee's return for such taxable year, or on or before October 24, 1972, whichever is later.

(3) *Election is irrevocable*. An election under this paragraph shall be irrevocable as of the time the statement referred to in subparagraph (1) of this paragraph is filed with the lessee.

(g) *General election*—(1) *In general*. In lieu of making elections on a property-by-property basis in the manner and time prescribed in paragraph (f) of this section, a lessor may, with respect to a particular taxable year of a particular lessee, make a general election to treat such lessee as having purchased all properties possession of which is transferred under lease by the lessor to the lessee during such taxable year of the lessee.

(2) *Manner and time for making general election*. The general election of a lessor with respect to a taxable year of a lessee shall be made by filing a statement

with the lessee, signed by the lessor and including the written consent of the lessee, on or before the due date (including any extensions of time) of the lessee's return for such taxable year, except that if such taxable year ends after March 31, 1971, and before December 11, 1971, the statement shall be filed with the lessee on or before the due date (including any extensions of time) of the lessee's return for such taxable year, or on or before October 24, 1972, whichever is later. Such statement of general election shall contain:

(i) The name, address, and taxpayer account number of the lessor and the lessee;

(ii) The taxable year of the lessee with respect to which such general election is made;

(iii) The district director's office with which the income tax returns of the lessor and the lessee are filed;

(iv) If the lessor is itself a lessee, the name, address, and taxpayer account number of the original lessor, and the district director's office with which the income tax return of such original lessor is filed.

(3) *Election is irrevocable.* A general election under this paragraph shall be irrevocable as of the time the statement referred to in subparagraph (2) of this paragraph is filed with the lessee and shall be binding on the lessor and the lessee for the entire taxable year of the lessee with respect to which such general election is made.

(4) *Information requirement.* If a lessor, with respect to a taxable year of the lessee, makes a general election under this paragraph, such lessor shall provide such lessee, on or before the date required for filing the statement under subparagraph (2) of this paragraph, with a statement (or statements) containing the information required by paragraphs (f)(1) (iii), (iv), (v), and (vi) of this section with respect to all properties possession of which is transferred under lease by the lessor to the lessee during such taxable year.

(h) *Signature.* The statement referred to in paragraph (f)(1) or (g)(2) of this section shall not be valid unless signed by both the lessor and the lessee. The signature of the lessee shall constitute the consent of the lessee to the election. The statement shall be signed by the taxpayer or a duly authorized agent of the taxpayer. For purposes of this section, a facsimile signature may be used in lieu of a signature manually executed and, if used, shall be as binding as a signature manually executed.

(i) [Reserved]

(j) *Record requirements.* The lessor and the lessee shall keep as a part of their records the statement referred to in paragraph (f)(1), or the statements referred to in paragraphs (g)(2) and (g)(4), of this section. The lessor shall attach to his income tax return a summary statement of all property leased during his taxable year with respect to which an election is made. In the case of a taxable year ending after March 31, 1971, and before December 11, 1971, a summary statement may be filed on or before the due date (including any extensions of time) of the return or on or before October 24, 1972, whichever is later, with the Internal Revenue Service Center with which the return has been filed. Such summary statement shall contain the following information: (1) The name, address, and taxpayer account number of the lessor; and (2) in numerical account number order, each lessee's account number, name, and address, the estimated useful life category of the property (or, if applicable, the estimated useful life expressed in years), and the basis or fair market value of the property, whichever is applicable.

(k) *Adjustment of rental deductions*—(1) *In general.* The rules of this paragraph apply only to section 38 property placed in service before January 1, 1964, and with respect to any such property only for taxable years of a lessee beginning before January 1, 1964. If a lessor makes a valid election under this section with respect to property placed in service by the lessee before January 1, 1964, section 48(g) and §1.48–7 (relating to adjustments to basis of property) shall not apply to the lessor with respect to such property. Thus, the lessor is not required to reduce under section 48(g)(1) the basis of such property. However, if such an election is made, the deductions otherwise allowable under section 162 to the lessee for amounts paid or accrued to the lessor under the lease shall be adjusted in the manner provided in this paragraph. For special adjustment for taxable years beginning after December 31, 1963, see paragraph (m) of this section.

(2) *Decrease in rental deduction.* (i) The deductions otherwise allowable under section 162 to the lessee for amounts paid or accrued to the lessor under the lease with respect to leased property placed in service before January 1, 1964, shall be decreased under subdivision (ii) or (iii) of this subparagraph, whichever is applicable, by an amount determined by reference to the credit earned on the leased property. The ''credit earned'' on the leased property is determined by multiplying the qualified investment (as defined in section 46(c)) with respect to such property by 7 percent. Thus, the credit earned (and the decrease in deductions) is determined without regard to the limitation based on tax which, under section 46(a)(2), may limit the amount of the credit the lessee may take into account in any one year.

(ii) If, in the case of property placed in service before January 1, 1964, the lessor, under paragraph (f)(1)(v) of this section, supplies the lessee with the useful life of such property expressed in years, then for each taxable year beginning before January 1, 1964, any part of which falls within a period beginning with the month in which the leased property is placed in service by the lessee and ending with the close of the estimated useful life of such property (as determined under paragraph (d) of this section), the lessee shall decrease the deduction otherwise allowable under section 162 for each such taxable year with respect to such property. The decrease for each such taxable year shall be equal to (*a*) the credit earned, divided by (*b*) the estimated useful life of the property (expressed in months), multiplied by (*c*) the number of calendar months in which the leased property was held by the lessee during such taxable year. Thus, if leased property with a basis of $27,000 in the hands of a calendar-year lessee, and with an estimated useful life of 10 years, is placed in service by the lessee on July 15, 1963, the lessee must decrease his section 162 deduction with respect to the leased property for the taxable year 1963 by $94.50 ($1,890 credit earned, divided by 120, multiplied by 6).

(iii) If, in the case of property placed in service before January 1, 1964, the lessor, under paragraph (f)(1)(v) of this section, supplies the lessee with the useful life category of such property, then for each taxable year beginning before January 1, 1964, during a period equal to the shortest life of the useful life category used by the lessee in computing qualified investment under section 46(c) with respect to the leased property, the lessee shall decrease the deduction otherwise allowable under section 162 for such taxable year with respect to such property. The decrease for each such taxable year shall be equal to the credit earned divided by such shortest life, that is, 4, 6, or 8. Such decreases shall begin with the taxable year during which the lessee places the property in service. Thus, if leased property with a basis of $30,000 to the lessee, and an estimated useful life falling within the 4 years or more but less than 6 years useful life category, is placed in service by the lessee within the lessee's taxable year ending December 31, 1962, the lessee must decrease his section 162 deduction with respect to the leased property for each of the taxable years 1962 and 1963 by $175 ($700 credit earned divided by 4).

(iv) To the extent that a required decrease, under subdivision (ii) or (iii) of this subparagraph, is not taken into account for any taxable year beginning before January 1, 1964, because the deduction otherwise allowable under section 162 for such taxable year with respect to the leased property is less than the required decrease for such taxable year, then the balance of the required decrease not taken into account for such taxable year shall decrease the amount otherwise allowable as a deduction under section 162 with respect to such property for the next succeeding taxable year (or years) beginning before January 1, 1964, if any, for which a deduction is allowable with respect to such property. Thus, if the required decrease with respect to leased property is $200 for 1962 but the lessee's deduction otherwise allowable under section 162 for such taxable year with respect to such property is only $50, the balance of $150 must be applied in 1963 to decrease the deduction otherwise allowable to the lessee with respect to the leased property for such taxable year.

(v) See paragraph (b) of § 1.48–7 for reduction of basis in the case of an actual purchase of leased property by a lessee (in a taxable year of such lessee beginning before January 1, 1964) who has been treated as a purchaser of such property under this section.

(3) *Increase in rental deductions on account of early disposition, etc.* (i) If, as a result of an early disposition, etc., in a taxable year beginning before January 1, 1964, with respect to leased property placed in service before such date, the lessee's tax is increased under section 47(a) (1) or (2), or an adjustment in a carryback or carryover is made under section 47(a)(3) by reduction of an unused credit, the rental deductions (if any) otherwise allowable under section 162 to such lessee for amounts paid or accrued to the lessor under the lease with respect to such property shall be increased in an amount equal to the total decreases previously made in the lessee's rental deductions under subparagraph (2) of this paragraph.

(ii) Except as provided in subdivision (iii) of this subparagraph, the increase in rental deductions described in subdivision (i) of this subparagraph shall be taken into account as an increase in rental deductions otherwise allowable under section 162 for the taxable year in which the early disposition, etc., occurred.

(iii) If, after the event which caused section 47(a) (1), (2), or (3) to apply the lessee continues the use of the property in a trade or business or in the production of income, the increase in rental deductions described in subdivision (i) of this subparagraph shall be taken into account ratably over the remaining portion of the useful life of the property which was used in making the decreases in rental deductions with respect to the property under subparagraph (2) of this paragraph.

(iv) If subdivision (iii) of this subparagraph applies, and if, prior to the expiration of the useful life of the property used in making the decreases in rental deductions, the lease is terminated other than by actual purchase of the property by the lessee, any increase in rental deductions not previously taken into account shall be taken into account as an increase in rental deductions for the taxable year in which the lease is terminated. In the case of an actual purchase of the property by the lessee, see paragraph (e) of § 1.48–7.

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

Example 1. X Corporation is engaged in the business of manufacturing and leasing new and reconstructed equipment which in its hands has an estimated useful life of 12 years. After December 31, 1961, X Corporation constructs machine no. 1 at a cost of $20,000 and reconstructs machine no. 2 at a cost of $5,000. On February 15, 1962, Y Corporation, a calendar-year taxpayer, leases both machines from X Corporation and places them in service. The fair market value of machine no. 1 on the date on which possession is transferred to Y is $25,200. Machine no. 1 would qualify as new section 38 property in Y's hands if it had been purchased by Y. If X elects to treat Y as the purchaser of machine no. 1, under paragraph (c)(2)(ii) of this section such machine will have a basis of $25,200 in Y's hands. Under paragraph (f)(1)(v) of this section, X supplies Y with an estimated useful life of 12 years (expressed in years rather than useful life category) with respect to machine no. 1 for purposes of determining Y's qualified investment. Y's credit earned with respect to the property is $1,764 (7 percent of $25,200). Under paragraph (k)(2)(ii) of this section, Y's deduction attributable to the leased property for 1962 will be decreased by $134.75 (credit earned of $1,764, divided by 144, multiplied by 11), and for 1963 such deduction will be decreased by $147 ($1,764, divided by 144, multiplied by 12). The election is not available with respect to machine no. 2 since a reconstructed machine would not constitute new section 38 property if Y had purchased it. In such case, while X cannot make the election to treat Y as a purchaser, X would be entitled to a credit under section 38 based on its expenditure of $5,000 as an investment in new section 38 property, since such amount represents cost of reconstruction after December 31, 1961.

Example 2. Assume the same facts as in example 1 except that under paragraph (f)(1)(v) of this section, X supplies Y with an estimated useful life category of 8 years or more (rather than an estimated useful life expressed in years) with respect to machine no. 1 for purposes of determining Y's qualified investment. Under paragraph (k)(2)(iii) of this section, Y's deduction attributable to the leased property will be decreased by

$220.50 (credit earned of $1,764, divided by 8) for each of its taxable years 1962 and 1963.

Example 3. Assume the same facts as in example 1 except that the lessee disposes of his interest in the lease on January 1, 1963, and that there is an increase in Y's tax for 1963 under section 47(a)(1) in the amount of $1,764. Under paragraph (k)(2) of this section, Y's deductions attributable to the leased property are decreased only in 1962, and the amount of such decrease is $134.75. In 1963 there shall be an increase of $134.75 in the deductions otherwise allowable under section 162 for such taxable year with respect to the leased property.

Example 4. Assume the same facts as in example 1 except that during the year 1963 the property was used by Y predominantly outside the United States within the meaning of paragraph (g) of §1.48–1, and thereafter was used in Y's trade or business. Under paragraph (k)(3) of this section, the increase of $134.75 described in example 3 is taken into account ratably as an increase in rental deductions otherwise allowable under section 162 in the amount of $12.25 ($134.75 divided by 11 years) for 1963 and each of the 10 succeeding years.

(m) *Increase in rental deductions on account of section 203(a)(2)(B) of the Revenue Act of 1964*—(1) *In general.* (i) Under section 203(a)(2)(B) of the Revenue Act of 1964, if, for any taxable year of a lessee beginning before January 1, 1964, the rental deductions otherwise allowable under section 162 to such lessee for amounts paid or accrued to the lessor under the lease with respect to leased property placed in service before January 1, 1964, were decreased under paragraph (k)(2) of this section, such rental deductions shall be increased.

(ii) The increase in rental deductions described in subdivision (i) of this subparagraph shall be in an amount equal to the total decreases in the lessee's rental deductions previously made under paragraph (k)(2) of this section less any increases in rental deductions made under paragraph (k)(3) of this section.

(iii) Except as provided in subdivision (iv) of this subparagraph, the increase in rental deductions described in subdivision (i) of this subparagraph shall be taken into account ratably over the remaining portion of the useful life of the property commencing with the first day of the first taxable year beginning after December 31, 1963. For this purpose, the useful life of the property shall be the useful life used in making the decreases in rental deductions with respect to the property under paragraph (k)(2) of this section.

(iv) If the lease is terminated other than by the lessee's actual purchase of the property during a taxable year beginning after December 31, 1963, and before the end of the remaining useful life of the property used in making the decreases in rental deductions, the amount of the increase in rental deductions described in subdivision (i) of this subparagraph and not previously taken into account shall be allowed as a deduction for the taxable year in which such termination occurs.

(v) The rental deductions with respect to any section 38 property are not to be increased under this paragraph if the lessee dies in a taxable year beginning before January 1, 1964.

(vi) The increase in rental deductions described in subdivision (i) of this subparagraph shall ordinarily be taken into account by the lessee treated as the purchaser, that is, the lessee entitled to the credit. However, if the property under the lease is transferred by the lessee to a successor lessee in a transaction described in section 47(b) (other than a transfer by reason of death) under which the successor lessee assumes the lessee's obligations under the lease, such increase in rental deductions shall be taken into account by the successor lessee in the manner prescribed in this paragraph.

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

Example 1. (a) X Corporation acquired on January 1, 1962, an item of new section 38 property with a basis of $24,000 and with a useful life to the lessor of 10 years. Y Corporation, which makes its returns on the basis of a calendar year, leased such property from X Corporation and placed it in service on January 2, 1962. Under this section, X Corporation made a valid election to treat Y Corporation as having purchased such property for purposes of the credit allowed by section 38 and supplied the lessee with information that the property had a useful life of 10 years. The amount of the credit earned with respect to such property was $1,680 (7 percent of $24,000). For each of the taxable years 1962 and 1963, Y Corporation decreased, under paragraph (k)(2) of this section, its deductions otherwise allowable under section

162 with respect to such property by $168 ($1,680 multiplied by $^{12}/_{120}$).

(b) For each of the taxable years 1964 through 1971, Y Corporation increases its deductions otherwise allowable under section 162 for amounts paid to X Corporation under the lease by $42 ($336 (that is, $168 multiplied by 2) divided by the remaining useful life of 8 years).

Example 2. (a) The facts are the same as in example 1 except that the lease is terminated on January 3, 1965.

(b) For the taxable year 1964, Y Corporation increases its deductions otherwise allowable under section 162 by $42.

(c) For the taxable year 1965, Y Corporation increases its deductions otherwise allowable under section 162 for the portion of the increase which had not been taken into account as of the time of the termination of the lease. Thus, the amount of such increase for the taxable year 1965 is $294 ($336 minus $42).

(Sec. 38, 76 Stat. 963; 26 U.S.C. 38)

[T.D. 6731, 29 FR 6080, May 8, 1964; 29 FR 7671, June 16, 1964, as amended by T.D. 6838, 30 FR 9060, July 20, 1965; T.D. 7203, 37 FR 17131, 17132, Aug. 25, 1972]

§ 1.48–5 Electing small business corporations.

(a) *In general.* (1) In the case of an electing small business corporation (as defined in section 1371(b)), the basis of ''new section 38 property'' and the cost of ''used section 38 property'' placed in service during the taxable year shall be apportioned pro rata among the persons who are shareholders of such corporation on the last day of such corporation's taxable year. Section 38 property shall not (by reason of such apportionment) lose its character as new section 38 property or used section 38 property, as the case may be. The estimated useful life of such property in the hands of a shareholder shall be deemed to be the estimated useful life of such property in the hands of the electing small business corporation. The bases of all new section 38 properties which have a useful life falling within a particular useful life category shall be aggregated; likewise, the cost of all used section 38 properties which have a useful life falling within a particular useful life category shall be aggregated. The total bases of new section 38 properties within each useful life category and the total cost of used section 38 properties within each useful life category shall be apportioned separately. The useful life categories are:

(i) 3 years or more but less than 5 years; (ii) 5 years or more but less than 7 years; and (iii) 7 years or more. There shall be apportioned to each person who is a shareholder of the electing small business corporation on the last day of the taxable year of such corporation, for his taxable year in which or with which the taxable year of such corporation ends, his pro rata share of the total bases of new section 38 properties within each useful life category, and his pro rata share of the total cost of used section 38 properties within each useful life category. In determining who are shareholders of an electing small business corporation on the last day of its taxable year, the rules of paragraph (d)(1) of §1.1371–1 and of paragraph (a)(2) of §1.1373–1 shall apply.

(2) The total cost of used section 38 property that may be apportioned by an electing small business corporation to its shareholders for any taxable year of such corporation shall not exceed $50,000. If the total cost of used section 38 property placed in service during the taxable year by the electing small business corporation exceeds $50,000 such corporation must select, under paragraph (c)(4) of §1.48–3, the used section 38 property the cost of which is to be apportioned to its shareholders.

(3) A shareholder to whom the basis (or cost) of section 38 property is apportioned shall, for purposes of the credit allowed by section 38, be treated as the taxpayer with respect to such property. Thus, the total cost of used section 38 property apportioned to him by the electing small business corporation must be taken into account as cost of used section 38 property in determining whether the $50,000 limitation on the cost of used section 38 property which may be taken into account by the shareholder in computing qualified investment for any taxable year is exceeded. If a shareholder takes into account in determining his qualified investment any portion of the basis (or cost) of section 38 property placed in service by an electing small business corporation and if such property subsequently is disposed of or otherwise ceases to be section 38 property in the

hands of the corporation, such shareholder shall be subject to the provisions of section 47. See § 1.47–4.

(b) *Summary statement.* An electing small business corporation shall attach to its return a statement showing the apportionment to each shareholder of the total bases of new, and the total cost of used, section 38 properties within each useful life category.

(c) *Example.* This section may be illustrated by the following example:

Example. 1 X Corporation, an electing small business corporation which makes its return on the basis of the calendar year, acquires and places in service on June 1, 1962, three new assets which qualify as new section 38 property and three used assets which qualify as used section 38 property. The basis of each new, and the cost of each used, section 38 property and the estimated useful life of each property are as follows:

Asset No.	Basis (or cost)	Estimated useful life
1 (new)	$30,000	4 years.
2 (new)	30,000	4 years.
3 (new)	30,000	8 years.
4 (used)	12,000	6 years.
5 (used)	12,000	6 years.
6 (used)	12,000	8 years.

On December 31, 1962, X Corporation has 10 shares of stock outstanding which are owned as follows: A owns 3 shares, B owns 2 shares, and C owns 5 shares.

(2) Under this section, the total bases of the new, and the total cost of the used, section 38 properties are apportioned to the shareholders of X Corporation as follows:

Useful life category	New—4 to 6 years	New—8 years or more	Used—6 to 8 years	Used—8 years or more
Total bases or total cost	$60,000	$30,000	$24,000	$12,000
Shareholder A (3⁄10)	18,000	9,000	7,200	3,600
Shareholder B (2⁄10)	12,000	6,000	4,800	2,400
Shareholder C (5⁄10)	30,000	15,000	12,000	6,000

Assume that shareholders A, B and C did not place in service during their taxable years in which falls December 31, 1962 (the last day of X Corporation's taxable year) any section 38 property and that such shareholders did not own any interests in other electing small business corporations, partnerships, estates, or trusts. Under section 46(c), the qualified investment of shareholder A is $23,400, of shareholder B is $15,600, and of shareholder C is $39,000, computed as follows:

Basis (or cost)	Applicable percentage	Qualified investment
SHAREHOLDER A		
$18,000 (new)	33⅓	$6,000
$9,000 (new)	100	9,000
$7,200 (used)	66⅔	4,800
$3,600 (used)	100	3,600
Total	....	23,400
SHAREHOLDER B		
$12,000 (new)	33⅓	$4,000
$6,000 (new)	100	6,000
$4,800 (used)	66⅔	3,200
$2,400 (used)	100	2,400
Total	....	15,600
SHAREHOLDER C		
$30,000 (new)	33⅓	$10,000
$15,000 (new)	100	15,000
$12,000 (used)	66⅔	8,000
$6,000 (used)	100	6,000
Total		39,000

[T.D. 6731, 29 FR 6082, May 8, 1964, as amended by T.D. 6931, 32 FR 14040, Oct. 10, 1967; T.D. 7203, 37 FR 17133, Aug. 25, 1972]

§ 1.48–6 Estates and trusts.

(a) *In general.* (1) In the case of an estate or trust, the basis of ''new section 38 property'' and the cost of ''used section 38 property'' placed in service during the taxable year shall be apportioned among the estate or trust and its beneficiaries on the basis of the income of such estate or trust allocable to each. Section 38 property shall not (by reason of such apportionment) lose its character as new section 38 property or used section 38 property, as the case may be. The estimated useful life of such property in the hands of a beneficiary shall be deemed to be the estimated useful life of such property in the hands of the estate or trust. The bases of all new section 38 properties which have a useful life falling within a particular useful life category shall be aggregated; likewise, the cost of all used section 38 properties which have a useful life falling within a particular useful life category shall be aggregated. The total bases of new section 38 properties within each useful life category and the total cost of used section 38 properties within each useful life category shall be apportioned separately. The useful life categories are:

(i) 3 years or more but less than 5 years; (ii) 5 years or more but less than 7 years; and (iii) 7 years or more. There shall be apportioned to the estate or trust for its taxable year, and to each beneficiary of such estate or trust for his taxable year in which or with which the taxable year of such estate or trust ends, his share (as determined under paragraph (b) of this section) of the total bases of new section 38 properties within each useful life category, and his share of the total cost of used section 38 properties within each useful life category.

(2) The total cost of used section 38 property that may be apportioned among an estate or trust and its beneficiaries for any taxable year of such estate or trust shall not exceed $50,000. If the total cost of used section 38 property placed in service during the taxable year by the estate or trust exceeds $50,000, such estate or trust must select, under paragraph (c)(4) of §1.48–3, the used section 38 property the cost of which is to be apportioned among such estate or trust and its beneficiaries.

(3) A beneficiary to whom the basis (or cost) of section 38 property is apportioned shall, for purposes of the credit allowed by section 38, be treated as the taxpayer with respect to such property. Thus, the total cost of used section 38 property apportioned to him by the estate or trust must be taken into account as cost of used section 38 property in determining whether the $50,000 limitation on the cost of used property which may be taken into account by the beneficiary in computing qualified investment for any taxable year is exceeded. If a beneficiary takes into account in determining his qualified investment any portion of the basis (or cost) of section 38 property placed in service by an estate or trust and if such property subsequently is disposed of or otherwise ceases to be section 38 property in the hands of estate or trust, such beneficiary shall be subject to the provisions of section 47. See §1.47–5.

(4) For purposes of this section, the term ''beneficiary'' includes heir, legatee, and devisee.

(5) If during the taxable year of an estate or trust a beneficiary's interest in the income of such estate or trust terminates, the basis (or cost) of section 38 property placed in service by such estate or trust after such termination shall not be apportioned to such beneficiary.

(b) *Share.* A trust's, estate's, or beneficiary's share of the total bases of new section 38 properties, and the total cost of used section 38 properties, within a useful life category shall be—

(1) The total bases of new (or the total cost of used) section 38 properties which have a useful life falling within such useful life category placed in service in the taxable year of the estate or trust, multiplied by

(2) The amount of income allocable to such estate or trust or to such beneficiary for such taxable year, divided by

(3) The sum of the amounts of income allocable to such estate or trust and all its beneficiaries taken into account under subparagraph (2) of this paragraph.

(c) *Limitation based on amount of tax.* In the case of an estate or trust, the $25,000 amount specified in section 46(a)(2), relating to limitation based on amount of tax, shall be reduced for the taxable year to—

(1) $25,000, multiplied by

(2) The qualified investment with respect to the total bases of new section 38 properties plus the qualified investment with respect to the total cost of used section 38 properties, apportioned to such estate or trust under paragraph (a) of this section, divided by

(3) The qualified investment with respect to the total bases of all new section 38 properties plus the qualified investment with respect to the total cost of all used section 38 properties, apportioned among such estate or trust and its beneficiaries.

For purposes of subparagraph (3) of this paragraph, cost of used section 38 property shall not be considered as apportioned to any beneficiary to the extent that such cost is not taken into account by such beneficiary in computing qualified investment in used section 38 property.

(d) *Summary statement.* An estate or trust shall attach to its return a statement showing the apportionment to such estate or trust and to each beneficiary of the total bases of new, and the total cost of used, section 38 properties within each useful life category.

(e) *Example.* This section may be illustrated by the following example:

Example. 1 XYZ Trust, which makes its return on the basis of the calendar year, acquires and places in service on June 1, 1962, three new assets which qualify as new section 38 property and three used assets which qualify as used section 38 property. The basis of the new, and the cost of the used, section 38 property and the estimated useful life of each property are as follows:

Asset No.	Basis (or cost)	Estimated useful life
1 (new)	$30,000	4 years.
2 (new)	30,000	4 years.
3 (new)	30,000	8 years.
4 (used)	12,000	6 years.
5 (used)	12,000	6 years.
6 (used)	12,000	8 years.

For the taxable year 1962 the income of XYZ Trust is $20,000 which is allocable as follows: $10,000 to XYZ Trust, $6,000 to beneficiary A, and $4,000 to beneficiary B. Beneficiaries A and B make their returns on the basis of a calendar year.

(2) Under this section, the total bases of the new, and the total cost of the used, section 38 properties are apportioned to XYZ Trust and its beneficiaries as follows:

Useful life category	New—4 to 6 years	New—8 years or more	Used—6 to 8 years	Used—8 years or more
Total bases or total cost	$60,000	$30,000	$24,000	$12,000
XYZ Trust ($10,000 ÷ 20,000)	30,000	15,000	12,000	6,000
Beneficiary A ($6,000 ÷ 20,000)	18,000	9,000	7,200	3,600
Beneficiary B ($4,000 ÷ 20,000)	12,000	6,000	4,800	2,400

Assume that beneficiary A placed in service during his taxable year 1962 new section 38 property with a basis of $10,000 and an estimated useful life of 8 years. Also, assume that beneficiary B did not place in service during his taxable year 1962 any section 38 property and that beneficiaries A and B did not own any interests in other trusts, estates, partnerships, or electing small business corporations. Under section 46(c), the qualified investment of XYZ Trust is $39,000, of beneficiary A is $33,400, and of beneficiary B is $15,600, computed as follows:

Basis (or cost)	Applicable percentage	Qualified investment
XYZ TRUST		
$30,000 (new)	33⅓	$10,000
$15,000 (new)	100	15,000
$12,000 (used)	66⅔	8,000
$6,000 (used)	100	6,000
Total	....	39,000
BENEFICIARY A		
$18,000 (new)	33⅓	$6,000
$9,000 (new)	100	9,000
$7,200 (used)	66⅔	4,800
$3,600 (used)	100	3,600
		23,400
$10,000 (new)	100	10,000
Total	....	33,400
BENEFICIARY B		
$12,000 (new)	33⅓	$4,000
$6,000 (new)	100	6,000
$4,800 (used)	66⅔	3,200
$2,400 (used)	100	2,400
Total	....	15,600

(3) In the case of XYZ Trust, the $25,000 amount specified in section 46(a)(2) is reduced to $12,500, computed as follows: (i) $25,000, multiplied by (ii) $39,000 (qualified investment apportioned to the trust), divided by (iii) $78,000 (total qualified investment apportioned among such trust ($39,000), beneficiary A ($23,400), and beneficiary B ($15,600)).

[T.D. 6731, 29 FR 6083, May 8, 1964, as amended by T.D. 6931, 32 FR 14040, Oct. 10, 1967; T.D. 6958, 33 FR 9171, June 21, 1968; T.D. 7203, 37 FR 17133, Aug. 25, 1972]

§ 1.48–9 Definition of energy property.

(a) *General rule*—(1) *In general.* Under section 48(l)(2), energy property means property that is described in at least one of 6 categories of energy property and that meets the other requirements of this section. If property is described in more than one of these categories, or is described more than once in a single category, only a single energy investment credit is allowed. In that case, the energy investment credit will be allowed under the category the taxpayer chooses by indicating the chosen category on Form 3468, Schedule B. The 6 categories of energy property are:

(i) Alternative energy property,

(ii) Solar or wind energy property,

(iii) Specially defined energy property,

(iv) Recycling equipment,

(v) Shale oil equipment, and

(vi) Equipment for producing natural gas from geopressured brine.

(2) *Depreciable property with 3-year useful life.* Property is not energy property unless depreciation (or amortization in lieu of depreciation) is allowable and the property has an estimated useful life (determined at the time when the property is placed in service) of 3 years or more.

(3) *Effective date rules.* To be energy property—

(i) If property is constructed, reconstructed or erected by the taxpayer, the construction, reconstruction, or erection must be completed after September 30, 1978, or

(ii) If the property is acquired, the original use of the property must (A) commence with the taxpayer and (B) commence after September 30, 1978, and before January 1, 1983.

For transitional rules, see section 48(m).

(4) *Cross references.* (i) To determine if depreciation (or amortization in lieu of depreciation) is allowable for property, see §1.48–1(b).

(ii) For the meaning of ''estimated useful life'', see §1.46–3(e)(7).

(iii) The meaning of ''acquired'', ''original use'', ''construction'', ''reconstruction'', and ''erection'' is determined under the principles of §1.48–2(b).

(iv) For the definition of energy investment credit (energy credit), see section 48(o)(2).

(v) For special rules relating to public utility property, see paragraph (n) of this section.

(b) *Relationship to section 38 property*—(1) *In general.* (i) Energy property is treated under section 48(l)(1) as meeting the general requirements for section 38 property set forth in section 48(a)(1). For example, structural components of a building may qualify for the energy credit. In addition, the exclusion from section 38 property under section 48(a)(3) (lodging limitation) does not apply to energy property. For purposes of the energy credit, energy property is treated as section 38 property solely by reason of section 48(l)(1). For example, if property ceases to be energy property, it ceases to be section 38 property for all purposes relating to the energy credit and, thus, if subject to recapture under section 47. See §1.47–1(h).

(ii) See the effective date rules under paragraph (a)(3) of this section for limitations on the eligibility of property as energy property.

(iii) Section 48(l)(1) does not affect the character of property under sections of the Code outside the investment credit provisions. For example, structural components of a building that are treated as section 38 property under section 48(l)(1) remain section 1250 property and are not section 1245 property.

(2) *Other section 48 rules apply.* (i) In general, section 48(a) otherwise applies in determining if energy property is section 38 property. Thus, energy property excluded from the definition of section 38 property under section 48(a) (except by reason of section 48(a)(1) or (a)(3)) is not eligible for the energy credit. For example, energy property used predominantly outside the United States (section 48(a)(2)) or used by tax exempt organizations (section 48(a)(4)), in general, is not treated as section 38 property for any purpose and thus, is not eligible for the energy credit.

(ii) Other rules of section 48, such as those for leased property under section 48(d), also apply to energy property.

(3) *Regular credit denied for certain energy property.* In computing the amount

of credit under section 46(a)(2), the regular percentage does not apply to any energy property which, but for section 48(l)(1), would not be section 38 property. See section 46(a)(2)(D). For example, energy property used for lodging (section 48(a)(3)) and, in general, structural components of a building (section 48(a)(1)(B)) re not eligible for the regular credit even though they may be eligible for the energy credit. However, a structural component of a qualified rehabilitated building (as defined in section 48(g)(1)) or a single purpose agricultural or horticultural structure (as defined in section 48(p)) may qualify for the regular credit without regard to section 48(l)(1).

(c) *Alternative energy property*—(1) *In general.* Alternative energy property means property described in paragraphs (c)(3) through (10) of this section. In general alternative energy property includes certain property that uses an alternate substance as a fuel or feedstock or converts an alternate substance to a synthetic fuel and certain associated equipment.

(2) *Alternate substance.* (i) An alternate substance is any substance or combination of substances other than an oil or gas substance. Alternate substances include coal, wood, and agricultural, industrial, and municipal wastes or by-products. Alternate substances do not include synthetic fuels or other products that are produced from an alternate substance and that have undergone a chemical change as described in paragraph (c)(5)(ii) of this section. For example, methane produced from landfills is not an alternate substance; rather it is a synthetic fuel produced from an alternate substance. However, preparing an alternate substance for use as a fuel or feedstock or for conversion into a fuel does not create a new product if no chemical change occurs. For example, pelletizing, drying, compacting, and liquefying do not result in a new product if no chemical change occurs.

(ii) The term ''oil or gas substance'' means—

(A) Oil or gas and

(B) Any primary product of oil or gas.

(iii) For the definition of primary product of oil or gas, see §1.993–3(g)(3)(i), (ii), and (vi). Thus, petrochemicals are not primary products of oil or gas.

(3) *Boiler.* (i) A boiler that uses an alternate substance as its primary fuel is alternative energy property.

(ii) A boiler is a device for producing vapor from a liquid. Boilers, in general, have a burner in which fuel is burned. A boiler includes a fire box, boiler tubes, the containment shell, pumps, pressure and operating controls, and safety equipment, but not pollution control equipment (as defined in paragraph (c)(8) of this section).

(iii) A ''primary fuel'' is a fuel comprising more than 50 percent of the fuel requirement of an item of equipment, measured in terms of Btu's for the remainder of the taxable year from the date the equipment is placed in service and for each taxable year thereafter. Electricity and waste heat are not fuels. For example, electric boilers do not qualify as alternative energy property even if the electricity is derived from an alternate substance.

(4) *Burners.* (i) A burner for a combustor other than a burner described in paragraph (c)(3)(ii) of this section is alternative energy property if the burner uses an alternate substance as its primary fuel (as defined in paragraph (c)(3)(iii) of this section).

(ii) A burner is the part of a combustor that produces a flame. A combustor is a process heater which includes ovens, kilns, and furnaces.

(iii) A burner includes equipment (such as conveyors, flame control devices, and safety monitoring devices) located at the site of the burner and necessary to bring the alternate substance to the burner.

(5) *Synthetic fuel production equipment.* (i) Equipment (synthetic fuel equipment) that converts an alternate substance into a synthetic solid, liquid, or gaseous fuel (other than coke or coke gas) is alternative energy property. Synthetic fuel production equipment does not include equipment, such as an oxygen plant, that is not directly involved in the treatment of an alternate substance, but produces a substance that is, like the alternate substance, a basic feedstock or catalyst used in the conversion process. Equipment is not eligible if it is used beyond the point at

which a substance usable as a fuel has been produced. Equipment is eligible only to the extent of the equipment's cost or basis allocable to the annual production of substances used as a fuel or used in the production of a fuel. For example, assume for the taxable year that 50 percent of the output of equipment is used to produce alcohol for production of whiskey and 50 percent is used to produce alcohol for use in a fuel mixture, such as gasohol. The alcohol production equipment qualifies as synthetic fuel equipment but only to the extent of one-half of its cost or basis. If, in a later taxable year, the equipment is used exclusively to produce whiskey, all of the equipment ceases to be synthetic fuel equipment.

(ii) A fuel is a material that produces usable heat upon combustion. To be ''synthetic'', the fuel either must differ significantly in chemical composition, as opposed to physical composition, from the alternate substance used to produce it or, in the case of solid fuel produced from biomass, the chemical change must consist of defiberization. Examples of synthetic fuels include alcohol derived from coal, peat, and vegetative matter, such as wood and corn, and methane from landfills.

(iii) Synthetic fuel equipment includes coal gasification equipment, coal liquefaction equipment, equipment for recovering methane from landfill, and equipment that converts biomass to a synthetic fuel.

(iv) Synthetic fuel equipment does not include equipment that merely mixes an alternate substance with another substance. For example, synthetic fuel equipment includes neither equipment that mixes coal and water to produce a slurry nor equipment that mixes alcohol and gasoline to produce gasohol. Equipment used to produce coke or coke gas, such as coke ovens, is also ineligible.

(6) *Modification equipment.* (i) Alternative energy property includes equipment (modification equipment) designed to modify existing equipment. For the definition of ''existing,'' see paragraph (l)(1)(i) of this section. To be eligible, the modification must result in a substitution for the remainder of the taxable year from the date the equipment is placed in service and for each taxable year thereafter of the items in paragraph (c)(6)(ii)(A) or (B) of this section for all or a portion of the oil or gas substance used as a fuel or feedstock. As a result of the modification, the substituted alternate substance must comprise at least 25 percent of the fuel or feedstock (determined on the basis of Btu equivalency). If the modification also increases the capacity of the equipment, only the incremental cost (as defined in paragraph (k) of this section) of the equipment qualifies.

(ii) The substitutes for an oil or gas substance are—

(A) An alternate substance or

(B) A mixture of oil and an alternate substance.

(iii) Modification equipment does not include replacements or a boiler of burner. If the boiler or burner is replaced, the items must be described in paragraph (c) (3) or (4) of this section to qualify as alternative energy property. Modification may include, however, replacements of components of a boiler or burner, such as a heat exchanger.

(iv) The following examples illustrate this paragraph (c)(6).

Example 1. On January 1, 1980, corporation X is using oil to fuel its boiler. On June 1, 1980, X modifies the boiler to permit substitution of a coal and oil mixture for 40 percent of X's oil fuel needs. The mixture consists 75 percent of oil and 25 percent of coal. The equipment modifying the boiler does not qualify as modification equipment because the alternate substance comprises only 10 percent of the fuel.

Example 2. Assume the same facts as in example 1 except 75 percent of the mixture is coal. The equipment modifying the boiler qualifies.

Example 3. Assume the same facts as in example 2 except, instead of substituting an oil and coal mixture for 40 percent of X's oil fuel needs, X uses the modification to expand the boiler's fuel capacity by 40 percent using the mixture as additional fuel. The additional fuel mixture comprises only 28 percent of X's total fuel needs. Thus, even though 75 percent of the additional fuel mixture is an alternate substance, the boiler does not qualify as modification equipment because the alternate substance comprises only 21 percent of the total fuel.

(7) *Equipment using coal as feedstock.* Equipment that uses coal (including lignite) to produce a feedstock for the

manufacture of chemicals, such as petrochemicals, or other products is alternative energy property. Equipment is not eligible if it is not directly involved in the treatment of coal or a coal product, but produces a substance that is, like coal, a basic feedstock or catalyst used in the coal conversion process. Equipment is not eligible if it is used beyond the point at which the first product marketable as a feedstock has been produced. Equipment used to produce coke or coke gas, such as coke ovens, is ineligible.

(8) *Pollution control equipment.* (i) Pollution control equipment is alternative energy property. Eligible equipment is limited to property or equipment to the extent it qualifies as a pollution control facility under section 103(b)(4)(F) and the regulations thereunder except that, if control of pollution is not the only significant purpose (within the meaning of those regulations), only the incremental cost (as defined in paragraph (k) of this section) of the equipment qualifies. However, if a Treasury decision changes the regulations under section 103(b)(4)(F) and, thus, the rules reflected in this subdivision (i), the rules as changed will apply as of the effective date of the Treasury decision.

(ii) To be eligible, the equipment must be required by a Federal, State, or local government regulation to be installed on, or used in connection with, eligible alternative energy property (as defined in paragraph (c)(8)(v) of this section).

(iii) Under section 48(l)(3)(D) equipment is not eligible if required by a Federal, State, or local government regulation in effect on October 1, 1978, to be installed on, or in connection with, property using coal (including lignite) as of October 1, 1978.

(iv) Under this subparagraph (8), pollution control equipment is required by regulation if it would be necessary to install the equipment to satisfy the requirements of any applicable law, including nuisance law. The pollution control equipment need not be specifically identified in the applicable law. If several different types of equipment may be used to comply with the applicable law, each type of equipment is considered necessary to satisfy the requirements of the law. An order permitting a taxpayer to delay compliance with any applicable law is disregarded.

(v) Under this subparagraph (8) ''eligible alternative energy property'' is energy property (as defined in section 48 (l)(2)) described in paragraphs (c) (3) through (7) of this section. If equipment otherwise qualifying as pollution control equipment is installed on, or used in connection with, both eligible alternative energy property and property other than eligible alternative energy property, only the incremental cost (as defined in paragraph (k) of this section) of the equipment qualifies.

(vi) *Examples.* The following examples illustrate this subparagraph (8). Assume that the property or equipment in the examples are described in § 1.103–8(g)(2)(ii) and that their only purpose is control of pollution.

Example 1. On October 1, 1978, corporation X acquires and places in service in State A a paper mill. The facility includes a boiler the primary fuel for which is wood chips. The facility includes equipment necessary to comply with pollution control standards in effect on October 1, 1978 in State A. This equipment qualifies as pollution control equipment.

Example 2. On October 1, 1978, corporation Y was burning coal at its facility in State B. The emissions from the facility exceeded State air pollution control requirements in effect on October 1, 1978. On January 1, 1979, X installed cyclone separators to comply with the State pollution control requirements. The cyclone separators do not qualify as pollution control equipment.

Example 3. Assume the same facts as in example 2 except that Y installs a baghouse instead of cyclone separators to meet more stringent standards that take effect on December 31, 1978. The baghouse qualifies as pollution control equipment because the baghouse was not necessary to meet the standards in effect on October 1, 1978.

Example 4. On October 1, 1978, corporation Z is burning coal at its facility in State C. The emissions from that facility exceed State air pollution control standards in effect on October 1, 1978. C orders Z to install cyclone separators before January 1, 1979. However, C allows Z to operate its facility until January 1, 1979, under less stringent interim standards applicable only to Z. The separators do not qualify as pollution control equipment. The delayed compliance order is disregarded.

(9) *Handling and preparation equipment.* (i) Alternative energy property

includes equipment (handling and preparation equipment) used for unloading, transfer, storage, reclaiming from storage, or preparation of an alternate substance for use in eligible alternative energy property (as defined in paragraph (c)(9)(ii) of this section). Handling and preparation equipment must be located at the site the alternate substance is used as a fuel or feedstock. For example, equipment used to screen and prepare coal for use at a power plant qualifies if located at the plant. However, similar equipment located at the coal mine would not qualify.

(ii) Under this subparagraph (9), ''eligible alternative energy property'' is energy property (as defined in section 48(l)(2)) described in paragraphs (c) (3) through (8) of this section. If equipment otherwise qualifying as handling and preparation equipment is installed on, or used in connection with, property other than eligible alternative energy property, only the incremental cost (as defined in paragraph (k) of this section) of the equipment qualifies.

(iii) The term ''preparation'' includes washing, crushing, drying, compacting, and weighing of an alternate substance. Handling and preparation equipment also includes equipment for shredding, chopping, pulverizing, or screening agricultural or forestry byproducts at the site of use.

(iv) Handling and preparation equipment does not include equipment, such as coal slurry pipelines and railroad cars, that transports a fuel or a feedstock to the site of its use.

(10) *Geothermal equipment*—(i) Alternative energy property includes equipment (geothermal equipment) that produces, distributes, or uses energy derived from a geothermal deposit (as defined in § 1.44C–2(h)).

(ii) In general, production equipment includes equipment necessary to bring geothermal energy from the subterranean deposit to the surface, including well-head and downhole equipment (such as screening or slotting liners, tubing, downhole pumps, and associated equipment). Reinjection wells required for production also may qualify. Production does not include exploration and development.

(iii) Distribution equipment includes equipment that transports geothermal steam or hot water from a geothermal deposit to the site of ultimate use. If geothermal energy is used to generate electricity, distribution equipment includes equipment that transports hot water from the geothermal deposit to a power plant. Distribution equipment also includes components of a heating system, such as pipes and ductwork that distribute within a building the energy derived from the geothermal deposit.

(iv) Geothermal equipment includes equipment that uses energy derived both from a geothermal deposit and from sources other than a geothermal deposit (dual use equipment). Such equipment, however, is geothermal equipment (A) only if its use of energy from sources other than a geothermal deposit does not exceed 25 percent of its total energy input in an annual measuring period and (B) only to the extent of its basis or cost allocable to its use of energy from a geothermal deposit during an annual measuring period. An ''annual measuring period'' for an item of dual use equipment is the 365 day period beginning with the day it is placed in service or a 365 day period beginning the day after the last day of the immediately preceding annual measuring period. The allocation of energy use required for purposes of paragraph (c)(10)(iv) (A) and (B) of this section may be made by comparing, on a Btu basis, energy input to dual use equipment from the geothermal deposit with energy input from other sources. However, the Commissioner may accept any other method that, in his opinion, accurately establishes the relative annual use by dual use equipment of energy derived from a geothermal deposit and energy derived from other sources.

(v) The existence of a backup system designed for use only in the event of a failure in the system providing energy derived from a geothermal deposit will not disqualify any other equipment. If geothermal energy is used to generate electricity, equipment using geothermal energy includes the electrical generating equipment, such as turbines and generators. However, geothermal equipment does not include any electrical transmission equipment, such as transmission lines and towers, or any equipment beyond the electrical transmission stage, such as transformers and distribution lines.

(vi) *Examples.* The following examples illustrate this subparagraph (10):

Example 1. On October 1, 1979, corporation X, a calendar year taxpayer, places in service a system which heats its office building by circulating hot water heated by energy derived from a geothermal deposit through the building. Geothermal equipment includes the circulation system, including the pumps and pipes which circulate the hot water through the building.

Example 2. The facts are the same as in Example 1, except that corporation X also places in service a boiler to produce hot water for heating the building exclusively in the event of a failure of the geothermal equipment. Such a boiler is not geothermal equipment, but the existence of such a backup system does not serve to disqualify property eligible in Example 1.

Example 3. The facts are the same as in Example 1, except that the water heated by energy derived from a geothermal deposit is not hot enough to provide sufficient heat for the building. Therefore, the system includes an electric boiler in which the water is heated before being circulated in the heating system. Assume that, on a Btu basis, eighty percent of the total energy input to the circulating system during the 365 day period beginning on October 1, 1979, is energy derived from a geothermal deposit. The boiler is not geothermal equipment. For the 1979 taxable year, eighty percent of the circulating system is geothermal equipment because eighty percent of its basis or cost is allocable to use of energy from a geothermal deposit. If, in a subsequent taxable year, the basis or cost allocable to use of energy from a geothermal deposit falls below eighty percent, recapture may be required under section 47 and §1.47–1(h). Thus, if, on a Btu basis, only 70 percent of the total energy input to the circulating system for the 365 day period beginning October 1, 1980, is energy derived from a geothermal deposit, then there will be complete recapture of the credit during the 1980 taxable year. If, however, for that 365 day period, the portion of the total energy input that is derived from a geothermal deposit is less than 80 percent but greater than or equal to 75 percent, then only a proportional amount of credit will be recaptured during the 1980 taxable year. No additional credit is allowable in a subsequent taxable year, however, if the portion of the basis or cost allocable to use of energy from a geothermal deposit increases above what it was for a previous taxable year (see §1.46–3(d)(4)(i)).

Example 4. Corporation Y acquires a commercial vegetable dehydration system in 1981. The system operates by placing fresh vegetables on a conveyor belt and moving them through a dryer. The conveyor belt is powered by electricity. The dryer uses solely energy derived from a geothermal deposit. The dryer is geothermal equipment while the equipment powered by electricity does not qualify.

(d) *Solar energy property*—(1) *In general.* Energy property includes solar energy property. The term ''solar energy property'' includes equipment and materials (and parts related to the functioning of such equipment) that use solar energy directly to (i) generate electricity, (ii) heat or cool a building or structure, or (iii) provide hot water for use within a building or structure. Generally, those functions are accomplished through the use of equipment such as collectors (to absorb sunlight and create hot liquids or air), storage tanks (to store hot liquids), rockbeds (to store hot air), thermostats (to activate pumps or fans which circulate the hot liquids or air), and heat exchangers (to utilize hot liquids or air to create hot air or water). Property that uses, as an energy source, fuel or energy derived indirectly from solar energy, such as ocean thermal energy, fossil fuel, or wood, is not considered solar energy property.

(2) *Passive solar excluded*—(i) Solar energy property excludes the materials and components of ''passive solar systems,'' even if combined with ''active solar systems.''

(ii) An active solar system is based on the use of mechanically forced energy transfer, such as the use of fans or pumps to circulate solar generated energy.

(iii) A passive system is based on the use of conductive, convective, or radiant energy transfer. Passive solar property includes greenhouses, solariums, roof ponds, glazing, and mass or water trombe walls.

(3) *Electric generation equipment.* Solar energy property includes equipment that uses solar energy to generate electricity, and includes storage devices, power conditioning equipment, transfer equipment, and parts related to the functioning of those items. In general, this process involves the transformation of sunlight into electricity through the use of such devices as solar cells or other collectors. However, solar energy property used to generate

electricity includes only equipment up to (but not including) the stage that transmits or uses electricity.

(4) *Pipes and ducts.* Pipes and ducts that are used exclusively to carry energy derived from solar energy are solar energy property. Pipes and ducts that are used to carry both energy derived from solar energy and energy derived from other sources are solar energy property (i) only if their use of energy other than solar energy does not exceed 25 percent of their total energy input in an annual measuring period and (ii) only to the extent of their basis or cost allocable to their use of solar energy during an annual measuring period. (See paragraph (d)(6) of this section for the definition of ''annual measuring period'' and for rules relating to the method of allocation.)

(5) *Specially adapted equipment.* Equipment that uses solar energy beyond the distribution stage is eligible only if specially adapted to use solar energy.

(6) *Auxiliary equipment.* Solar energy property does not include equipment (auxiliary equipment), such as furnaces and hot water heaters, that use a source of power other than solar or wind energy to provide usable energy. Solar energy property does include equipment, such as ducts and hot water tanks, which is utilized by both auxiliary equipment and solar energy equipment (dual use equipment). Such equipment is solar energy property (i) only if its use of energy from sources other than solar energy does not exceed 25 percent of its total energy input in an annual measuring period and (ii) only to the extent of its basis of cost allocable to its use of solar or wind energy during an annual measuring period. An ''annual measuring period'' for an item of dual use equipment is the 365 day period beginning with the day it is placed in service or a 365 day period beginning the day after the last day of the immediately preceding annual measuring period. The allocation of energy use required for purposes of paragraphs (d)(6) (i) and (ii) of this section may be made by comparing, on a Btu basis, energy input to dual use equipment from solar energy with energy input from other sources. However, the Commissioner may accept any other method that, in his opinon, accurately establishes the relative annual use by dual use equipment of solar energy and energy derived from other sources.

(7) *Solar process heat equipment.* Solar energy property does not include equipment that uses solar energy to generate steam at high temperatures for use in industrial or commercial processes (solar process heat).

(8) *Example.* The following example illustrates this paragraph (d).

Example. (a) In 1979, corporation X, a calendar year taxpayer, constructs an apartment building and purchases equipment to convert solar energy into heat for the building. Corporation X also installs an oil-fired water heater and other equipment to provide a backup source of heat when the solar energy equipment cannot meet the energy needs of the building. For purposes of this example, all equipment is placed in service on October 1, 1979. On a Btu basis, eighty percent of the total energy input to the dual use equipment during the 365 day period beginning October 1, 1979, is from solar energy.

(b) The items purchased, in addition to the water heater, include a roof solar collector, a heat exchanger, a hot water tank, a control component, pumps, pipes, fan-coil units, and valves. Assume the fan-coil units could be used with energy derived from an oil or gas substance without significant modification. All items are depreciable and have a useful life of three years or more. The use of the equipment to heat the building is the first use to which the equipment has been put.

(c) Water is pumped from the basement through pipes to the roof solar collector. Heated water returns through pipes to a heat exchanger which transfers heat to the water in the hot water tank.

(d) The hot water tank and the oil-fired water heater utilize the same distribution pipe. Pumps and valves at the points of connection between the hot water tank, the oil-fired water heater, and the distribution pipe regulate the auxiliary energy supply use. They also prevent the oil-fired water heater from heating water in the hot water tank.

(e) An integrated control component determines whether hot water from the hot water tank or from the oil-fired water heater is distributed to fan-coil units located throughout the building.

(f) The roof solar collector is solar energy property. The pump that moves the water to the roof collector and the pipes between the roof collector and the hot water tank qualify because they are solely related to transporting solar heated water. The hot water tank qualifies because it stores water heated solely by solar radiation. The heat exchanger also qualifies.

(g) The oil-fired water heater does not qualify as solar energy property because it is auxiliary equipment.

(h)(1) Because the distribution pipe, the control component, and the pumps and valves serve the oil-fired water heater as well as the solar energy equipment; they qualify only to the extent of eighty percent of their cost or basis, the portion allocable to use of solar energy. If, in a subsequent taxable year, the basis or cost allocable to their use of solar energy falls below eighty percent, recapture may be required under section 47 and §1.47–1(h). Thus, if, on a Btu basis, only 70 percent of the total energy input to that equipment for the 365 day period beginning October 1, 1980, is from solar energy, then there will be complete recapture of the credit during the 1980 taxable year. If, however, for that 365 day period, the portion of that equipment's total energy input that is from solar energy is less than 80 percent but greater than or equal to 75 percent, then only a proportional amount of credit will be recaptured during the 1980 taxable year. No additional credit is allowable for the equipment in a subsequent taxable year, however, if the portion of its basis or cost allocable to use of solar energy increases above what it was for a previous taxable year (see §1.46–3 (d)(4)(i)).

(2) The fan-coil units do not qualify as solar energy property because they are not specially adapted to use energy derived from solar energy.

(e) *Wind energy property*—(1) *In general.* Energy property includes wind energy property. Wind energy property is equipment (and parts related to the functioning of that equipment) that performs a function described in paragraph (e)(2) of this section. In general, wind energy property consists of a windmill, wind-driven generator, storage devices, power conditioning equipment, transfer equipment, and parts related to the functioning of those items. Wind energy property does not include equipment that transmits or uses electricity derived from wind energy. In addition, limitations apply similar to those set forth in paragraphs (d) (5), (6), and (8) of this section. For example, if equipment is used by both auxiliary equipment and wind energy equipment, such equipment is wind energy property only if its use of energy other than wind energy does not exceed 25 percent of its total energy input in an annual measuring period and only to the extent of its basis or cost allocable to its use of wind energy during an annual measuring period.

(2) *Eligible functions.* Wind energy property is limited to equipment (and parts related to the functioning of that equipment) that—

(i) Uses wind energy to heat or cool, or provide hot water for use in, a building or structure, or

(ii) Uses wind energy to generate electricity (but not mechanical forms of energy).

(f) *Specially defined energy property*—(1) *In general.* Specially defined energy property means only those items described in paragraphs (f) (4) through (14) of this section that meet the requirements of paragraph (f)(2) of this section. The items described in paragraphs (f) (4) through (14) of this section also consist of related equipment, such as fans, pumps, ductwork, piping, and controls, the installation of which is necessary for the specified item to reduce the energy consumed or heat wasted by the process.

(2) *General requirements.* To be eligible, each item described in paragraphs (f) (4) through (14) of this section must be installed in connection with an existing industrial or commercial facility. In addition, the principal purpose of each of those items must be reduction of energy consumed or heat wasted in any existing industrial or commercial process. See section 48(l)(10) and paragraph (l) of this section. If an item performs more than one function, only the incremental cost (as defined in paragraph (k) of this section) of the equipment qualifies.

(3) *Industrial or commercial process.* (i) A process is a means or method of producing a desired result by chemical, physical, or mechanical action. For example, equipment installed in connection with retail sales, general office use, and residential use are not used in a process within the meaning of this paragraph (f)(3).

(ii) An industrial process includes agricultural processes and thermal processes relating to production or manufacture, such as those involving boilers and furnaces.

(iii) A commercial process includes laundering and food preparation.

(iv) More than one process may be conducted in a single facility. The fact that several processes involved in the production of a product are integrated does not cause such integrated processes to be treated as one process. For example, in a food canning facility, producing prepared food from fresh vegetables is not one process but rather an integration of several processes including washing, cooking and canning.

(v) The following example illustrates this paragraph (f)(3).

Example. Corporation X, an advertising agency, acquires an automatic energy control system designed to reduce energy consumed by heating and cooling its office building. Although the use of an office for X's business is a commercial activity, heating or cooling an office is not an industrial or commercial process. The automatic energy control system does not qualify because it does not reduce energy consumed in an industrial or commercial process.

(4) *Recuperators.* Recuperators recover energy, usually in the form of waste heat from combustion exhaust gases, hot exiting product, or product cooling air, that is used to heat incoming combustion air, raw materials, or fuel. Recuperators are configurations of equipment consisting in part of fixed heat transfer surfaces between two gas flows, and include related baffles, dividers, entrance flanges, transition sections, and shells or cases enclosing the other components of the recuperator. In general, a fixed heat transfer surface absorbs heat from a gas or liquid flow or dissipates heat to the gas or liquid flow.

(5) *Heat wheels.* Heat wheels recover energy, usually in the form of waste heat, from exhaust gases to preheat incoming gases. Heat wheels are items of equipment consisting in part of regenerators (which rotate between two gas flows) and related drive components, wiper seals, entrance flanges, and transition sections.

(6) *Regenerators.* Regenerators are devices, such as clinker columns or chains, that recover energy by efficiently storing heat while exposed to high temperature gases and releasing heat while exposed to low temperature gases, fluids, or solids.

(7) *Heat exchangers.* Heat exchangers recover energy, usually in the form of waste heat, from high temperature gases, liquids, or solids for transfer to low temperature gases, liquids, or solids. Heat exchangers consist in part of fixed heat transfer surfaces (described in paragraph (f)(4) of this section) separating two media. Heat exchange equipment does not include fluidized bed combustion equipment.

(8) *Waste heat boilers.* Waste heat boilers use waste heat, usually in the form of combustion exhaust gases, as a substantial source of energy. A substantial source of energy is one that comprises more than 20 percent of the energy requirement on the basis of Btu's during the course of each taxable year (including the start-up year).

(9) *Heat pipes.* Heat pipes recover energy, usually in the form of waste heat, from high temperature fluids to heat low temperature fluids. A heat pipe consists in part of sealed heat transfer chambers and a capillary structure. In general, the heat transfer chambers alternatively vaporize and condense a working fluid as it passes from one end of the chamber to the other.

(10) *Automatic energy control systems.* Automatic energy control systems automatically reduce energy consumed in an industrial or commercial process for such purposes as environmental space conditioning (*i.e.*, lighting, heating, cooling or ventilating, etc.). Automatic energy control systems include, for example, automatic equipment settings controls, load shedding devices, and relay devices used as part of such system. Property such as computer hardware installed as a part of the energy control system also qualifies, but only to the extent of its incremental cost (as defined in paragraph (k) of this section).

(11) *Turbulators.* Turbulators increase the rate of transfer of heat from combustion gases to heat exchange surfaces by increasing the turbulence in the gases. A turbulator is a baffle placed in a boiler firetube or in a heat exchange tube in industrial process equipment to deflect gases to the heat transfer surface.

(12) *Preheaters.* Preheaters recover energy, usually in the form of waste heat, from either combustion exhaust gases or steam, to preheat incoming combustion air or boiler feedwater. A preheater consists in part of fixed heat

transfer surfaces (described in paragraph (f)(4) of this section) separating two fluids.

(13) *Combustible gas recovery systems.* Combustible gas recovery systems are items of equipment used to recover unburned fuel from combustion exhaust gases.

(14) *Economizers.* Economizers are configurations of equipment used to reduce energy demand or recover energy from combustion exhaust gases and other high temperature sources to preheat boiler feedwater.

(15) *Other property added by the Secretary.* [Reserved]

(g) *Recycling equipment*—(1) *In general.* Recycling equipment is equipment used exclusively to sort and prepare, or recycle, solid waste (other than animal waste) to recover usable raw materials (''recovery equipment''), or to convert solid waste (including animal waste) into fuel or other useful forms of energy (''conversion equipment''). Recycling equipment may include certain other onsite related equipment.

(2) *Recovery equipment.* Recovery equipment includes equipment that—

(i) Separates solid waste from a mixture of waste,

(ii) Applies a thermal, mechanical, or chemical treatment to solid waste to ensure the waste will properly respond to recycling, or

(iii) Recycles solid waste to recover usable raw materials, but not beyond occurrence of the first of the following:

(A) The point at which a material has been created that can be used in beginning the fabrication of an end-product in the same way as materials from a virgin substance. Examples are the fiber stage in textile recycling, the newsprint or paperboard stage in paper recycling, and the ingot stage for other metals (other than iron and steel). In the case of recycling iron or steel, recycling equipment does not include any equipment used to reduce solid waste to a molten state or any process thereafter.

(B) The point at which the material is a marketable product (*i.e.,* has a value other than for recycling) even if the material is not marketed by the taxpayer at that point.

(3) *Conversion equipment.* Conversion equipment includes equipment that converts solid waste into a fuel or other usable energy, but not beyond the point at which a fuel, steam, electricity, hot water, or other useful form of energy has been created. Thus, combustors, boilers, and similar equipment may be eligible if used for a conversion process, but steam and heat distribution systems between the combustor or boiler and the point of use are not eligible.

(4) *On-site related equipment.* Recycling equipment also includes onsite loading and transportation equipment, such as conveyors, integrally related to other recycling equipment. This equipment may include equipment to load solid waste into a sorting or preparation machine and also a conveyor belt system that transports solid waste from preparation equipment to other equipment in the recycling process.

(5) *Solid waste.* (i) The term ''solid waste'' has the same meaning as in §1.103–8(f)(2)(ii)(*b*), subject to the following exceptions and the other rules of this subparagraph (5):

(A) The date the equipment is placed in service is substituted in the first sentence of §1.103–8(f)(2)(ii)(*b*) for the date of issue of the obligations, and

(B) Material that has a market value at the place it is located only by reason of its value for recycling is not considered to have a market value.

(ii) Solid waste may include a nominal amount of virgin materials, liquids, or gases, not to exceed 10 percent. If more than 10 percent of the material recycled during the course of any taxable year (including the ''start up'' year) consists of virgin material, liquids, or gases, the equipment ceases to be energy property and is subject to recapture under section 47. The determination of the portion of virgin material, liquids, or gases used is based on volume, weight, or Btu's whichever is appropriate.

(6) *Ineligible equipment.* Transportation equipment, such as trucks, that transfer solid waste between geographically separated sites (e.g., the collection point and the recycling point) is not eligible. Steam and heat distribution systems are also ineligible.

(7) *Increased recycling capacity.* If the equipment both replaces recycling capacity and increases that capacity at a

particualr site, only the incremental cost (as defined in paragraph (k) of this section) of increasing the capacity qualifies. Recycling capacity is determined by the ability to produce a product not previously produced by the taxpayer, or more of an existing product, in a way that does not lower overall production.

(8) *Examples.* The following examples illustrate this paragraph (g).

Example 1. Corporation W recycles aluminum scrap metal. W owns a junk yard where it collects and crushes the metal into compact units. W's trucks bring the scrap metal from the junk yard to its main plant located 3 miles away. W's furnace equipment at the main plant reduces the scrap to the molten state and W's rolling equipment rolls the aluminum into sheets. The furnace qualifies, but for two separate reasons the rolling equipment does not qualify. First, the molten aluminum would be a marketable product if reduced to ingots prior to rolling. It is not necessary that W actually reduce the molten aluminum to ingots. Second, the molten aluminum could be used in the same way as virgin material.

Example 2. Corporation X manufactures newsprint using wood chips discarded during X's lumber operations. Assume X could sell the wood chips to other companies located a short distance from X's mill for use as a fuel. None of the equipment used to manufacture the newsprint qualifies.

Example 3. Assume the same facts as in example 2 except X uses old newspapers which have no value except for recycling in the area where X's mill is located. The equipment qualifies.

Example 4. Corporation Y recycles municipal waste. Assume the municipal waste is ''solid waste'' under paragraph (g)(5) of this section. During the first taxable year Y operates the equipment, Y uses 8,500 pounds of municipal waste and 1,500 pounds of virgin material and liquids. No energy credit is allowed for the equipment.

Example 5. Corporation Z owns a waste recovery facility. The corrugated paper portion of the waste stream is picked off a conveyor as it enters the facility. The corrugated paper is baled and sold as a secondary paper product. Z acquires shredding and air-classification equipment. Corrugated paper that is not removed from the conveyor belt enters the new equipment for production as a fuel. Z increases the input of corrugated paper so that the same amount of corrugated paper is removed from the conveyor to be baled. The excess paper that is not removed for baling enters the shredding and air-classification equipment. The new equipment qualifies.

(h) *Shale oil equipment*—(1) *In general.* Shale oil equipment used in mining or either surface or *in situ* processing qualifies as energy property. Shale oil equipment means equipment used exclusively to mine, or produce or extract oil from, shale rock.

(2) *Eligible processes.* In general, processing equipment qualifies if used in or after the mining stage and up through the retorting process. Thus, eligible processes include crushing, loading into the retort, and retorting, but not hydrogenation, refining, or any process subsequent to retorting. However, with respect to *in situ* processing, eligible processes include creating the underground cavity.

(3) *Eligible equipment.* Shale oil equipment includes—

(i) Heading jumbos, bulldozers, and scaling and bolting rigs used to create an underground cavity for *in situ* processing,

(ii) On-site water supply and treatment equipment and handling equipment for spent shale.

(iii) Crushing and screening plant equipment, such as hoppers, feeders, vibrating screens, and conveyors,

(iv) Briquetting plant equipment, such as hammer mills and vibratory pan feeders, and

(v) Retort equipment, including direct cooling and condensing equipment.

(i) [Reserved]

(j) *Natural gas from geopressured brine.* Equipment used exclusively to extract natural gas from geopressured brine described in section 613A(b)(3)(C)(i) is energy property. Eligible equipment includes equipment used to separate the gas from saline water and remove other impurities from the gas. Equipment is eligible only up to the point the gas may be introduced into a pipeline.

(k) *Incremental cost.* The term ''incremental cost'' means the excess of the total cost of equipment over the amount that would have been expended for the equipment if the equipment were not used for a qualifying purpose. For example, assume equipment costing $100 performs a pollution control function and another function. Assuming it would cost $60 solely to perform the nonqualifying function, the incremental cost would be $40.

(l) *Existing*—(1) *In general.* For purposes of section 48(l), the term ''existing'' means—

(i) When used in connection with a facility or equipment, 50 percent or more of the basis of that facility or equipment is attributable to construction, reconstruction, or erection before October 1, 1978, or

(ii) When used in connection with an industrial or commercial process, that process was carried on in the facility as of October 1, 1978.

(2) *Industrial or commercial process.* (i) A process will be considered the same as the process carried on in the facility as of October 1, 1978, unless and until capitalizable expenditures are paid or incurred for modification of the process. The expenditures need not be capitalized in fact; it is sufficient if the taxpayer has an option or may elect to capitalize. In general, the date of change will be the date the expenditures are properly chargeable to capital account. If the taxpayer properly elects to expense a capitalizable expenditure, the date of change will be the date the expenditure could have been properly chargeable to capital account if the expenditure had been capitalized. Recapture will not occur by reason of a change in a process unless the process change also changes the use of the equipment. See example (1) of § 1.47–1(h)(5).

(m) *Quality and performance standards*—(1) *In general.* Energy property must meet quality and performance standards, if any, that have been prescribed by the Secretary (after consultation with the Secretary of Energy) and are in effect at the time of acquisition.

(2) *Time of acquisition.* Under this paragraph (m) the time of acquisition is—

(i) The date the taxpayer enters into a binding contract to acquire the property or

(ii) For property constructed, reconstructed, or erected by the taxpayer, (A) the earlier of the date it begins construction, reconstruction, or erection of the property, or (B) the date the taxpayer and another person enter into a binding contract requiring each to construct, reconstruct, or erect property and place the property in service for an agreed upon use. See example under paragraph (m)(4) of this section.

(3) *Binding contract.* Under this paragraph (m), a binding contract to construct, reconstruct, or erect property, or to acquire property, is a contract that is binding at all times on the taxpayer under applicable State or local law. A binding contract to construct, reconstruct, or erect property or to acquire property, does not include a contract for preparation of architect's sketches, blueprints, or performance of any other activity not involving the beginning of physical work.

(4) *Example.* The following example illustrates this paragraph (m).

Example. Corporation X owns a junk yard. Corporation Y manufactures recycling equipment and operates several recycling facilities. On January 1, 1979, X and Y enter into a written contract that is binding on both parties on that date and at all times thereafter. Under the contract's terms X will supply scrap metals to Y and Y agrees in return to build a recycling facility on land adjacent to the junk yard. Y will own and operate the facility using the scrap metal supplied by X. Y may treat the agreement as a binding contract under paragraph (m) (2) and (3) of this section.

(n) *Public utility property*—(1) *Inclusions.* Public utility property is included in both of the following categories of energy property:

(i) Shale oil equipment and

(ii) Equipment for producing natural gas from geopressured brine.

(2) *Exclusions.* Public utility property is excluded from each of the following categories of energy property:

(i) Alternative energy property,

(ii) Specially defined energy property,

(iii) Solar or wind energy property, and

(iv) Recycling equipment.

(3) *Public utility property.* The term ''public utility property'' has the meaning given in section 46(f)(5).

(o)–(p) [Reserved]

(q) *Qualified intercity buses*—(1) *In general.* This paragraph (q) prescribes rules and definitions for purposes of section 48(l)(2)(A)(ix) and (16). Energy property includes qualified intercity buses of an eligible taxpayer, but only to the extent of the increase in the taxpayer's total operating seating capacity (operating capacity) under paragraphs (q) (9), (10), and (11) of this section. For application of recapture rules see § 1.47–1(h)(3)(ii).

(2) *Eligible taxpayer*. A taxpayer is an eligible taxpayer only if it is determined to be both—

(i) A common carrier regulated by the Interstate Commerce Commission or an appropriate State agency and

(ii) Engaged in the trade or business of furnishing intercity transportation by bus.

(3) *Common carrier*. The taxpayer is a common carrier only if the taxpayer holds itself out to the general public as providing passenger bus transportation for compensation over regular or irregular routes, or both.

(4) *Appropriate State agency*. A State agency is appropriate only if it has both—

(i) Power to regulate intrastate transportation provided by a motor carrier, within the meaning of section 10521(b)(1) of the Revised Interstate Commerce Act (49 U.S.C. 10521(b)(1)), and

(ii) Power to initiate an exemption proceeding under section 1025(b) of that Act (49 U.S.C. 10525(b)).

(5) *Intercity transportation*. Intercity transportation means intercity passenger transportation or intercity passenger charter service. Intercity transportation does not include transportation provided entirely within a municipality, contiguous municipalities, or within a zone that is adjacent to, and commercially a part of, the municipality or municipalities (within the meaning of section 10526(b)(1) of the Revised Interstate Commerce Act (49 U.S.C. 10526(b)(1)). See 49 CFR part 1048 (regulations defining commercial zones under that statute).

(6) *Definition of qualified intercity bus*. A qualified intercity bus (qualifying bus) is an automobile bus—

(i) The chassis and body of which are exempt (under section 4063(a)(6)) from the 10-percent excise tax generally imposed under section 4061(a) on trucks and buses.

(ii) With a seating capacity of at least 36 passengers (in addition to the driver).

(iii) With one or more baggage compartments, in an area separated from the passenger area, with an aggregate capacity of at least 200 cubic feet, and

(iv) Which meets the predominant use test.

(7) *Predominant use test*. (i) A bus meets the predominant use test for a taxable year only if it meets the following conditions:

(A) It is used on a full-time basis during the taxable year, and

(B) At least 70 percent of the total miles driven are driven while furnishing intercity transportation.

(ii) A bus driven from the end point of one trip to the beginning point of another trip (''deadheading''), both of which furnish intercity transportation of passengers, will be considered to have been driven while furnishing intercity transportation of passengers, even if no passengers are carried.

(iii) A bus is considered used on a full-time basis in a taxable year if it was driven 10,000 miles in that year. If available, the best evidence of annual mileage is the difference between odometer readings at the beginning and end of each taxable year. If the bus was placed in service during the taxable year, or for a short taxable year described in section 441(b)(3), that 10,000 mile figure is prorated on a daily basis.

(iv) If a qualifying bus fails to meet the predominant use test in a taxable year, a cessation occurs in that taxable year. See § 1.47–1(h)(3)(ii).

(v) The following examples illustrate this paragraph (q)(7):

Example 1. X, a bus company, used a bus for trips between city M and city N, a distance of 100 miles. These trips qualify as furnishing intercity transportation. During the taxable year, 300 round trips were run carrying passengers both ways and 75 trips were run carrying passengers from city M to city N immediately after each of which the bus was returned to city M for the next trip. The bus was also driven 20,000 miles to furnish passenger service which was local transportation. During the taxable year, the bus was driven a total of 100,000 miles. X makes the following calculations to determine if it met the predominant use test for the taxable year.

1. Total miles driven	100,000
2. Intercity miles driven:	
a. Passenger round trips (100 × 2 × 300)	60,000

b. Passenger one-way (75 × 100)	7,500
c. Non-passenger return trips (75 × 100)	7,500
3. Total intercity passenger miles (sum of lines 2 a, b, and c)	75,000
4. 79% of line 1	70,000

Since line 1 is not less than 10,000 miles, the full-time use requirement is met. Since line 3 is greater than line 4, the 70 percent intercity mileage test is met. Thus, for the taxable year, the bus meets the predominant use test in paragraph (q)(7)(i) of this section.

Example 2. The facts are the same as in example 1, except that the bus was placed in service on the last day of the taxable year. The bus was used only to run one round trip, carrying passengers, between cities M and N. 10,000 miles X one day ÷ 365 days = 27.4 miles. Because, for the one day of the taxable year that the bus was in service, the bus was driven more than 27.4 miles, and all these miles were driven to furnish intercity transportation, it met the predominant use test for the taxable year.

(8) *Leased buses.* (i) A bus which is leased is energy property only if it meets the requirements of paragraphs (q)(6) (i), (ii), and (iii) of this section, the lessee is an eligible taxpayer, and the bus meets the predominant use test in the hands of the lessee. If a leased bus is energy property, the energy credit is available only to the lessee unless paragraph (q)(8)(ii) of this section applies. The lessor must elect under section 48(d) for the lessee to claim the energy credit.

(ii) If a leased bus is energy property and, on or before October 9, 1984, either (A) the lessor and lessee enter into a lease and the lessee places the bus in service, or (B) the bus is not placed in service but the lessor and lessee enter into a binding contract under which the amount of the lease payments cannot be modified, then the energy credit is available to the lessor even if the lessor is not an eligible taxpayer.

(iii) Notwithstanding § 1.47–2(b)(1) (relating to the effect of a disposition by the lessee on the credit claimed by the lessor), if, by reason of a lease or the termination of a lease, a bus is used in a taxable year subsequent to the credit year by a person other than the one whose increase in operating capacity determined the amount of qualified investment for the energy credit, a disposition of the bus under § 1.47–1(h)(2) results. However, if the energy credit for a bus was earned in a taxable year and a lease of the bus which qualifies under section 168(f)(8) (safe-harbor lease) is entered into in a subsequent taxable year, the safe-harbor lease is not a disposition of the bus and the lessee under that lease is treated as the lessee for purposes of this paragraph (q)(8). For the requirement to file an amended return if the energy credit was allowed in a prior taxable year, see § 5c.168(f)(8)–6(b)(2)(ii) (Temporary Income Tax Regulations under the Economic Recovery Tax Act of 1981). For the rule for determining whose operating capacity determines qualified investment for the energy credit, see paragraph (q)(9)(ii) of this section. For the rule for leases to related taxpayers, see paragraph (q)(10)(ii) of this section.

(9) *Operating capacity.* (i) Qualified investment for a qualifying bus is taken into account for the energy credit only to the extent the bus increases the taxpayer's operating capacity. To increase operating capacity, a bus must be counted in operating capacity. The increase in a taxpayer's operating capacity is the excess of the taxpayer's operating capacity for the current taxable year over its operating capacity for the immediately preceding taxable year. Related taxpayers determine operating capacity on a group basis under paragraph (q)(10) of this section.

(ii) Operating capacity for a particular taxable year is determined by adding together the seating capacities of all intercity buses used by the taxpayer in that year and still owned by the taxpayer at the end of that year. An intercity bus is a bus which meets the chassis and body test and the predominant use test in paragraph (q)(6) of this section whether or not the bus is still in use at the end of the taxable year. In the case of a leased bus to which paragraph (q)(8) of this section applies, the lessee's operating capacity determines qualified investment for the energy credit.

(iii) The qualified investment for the energy credit for a qualifying bus is the bus's qualified investment for the regular credit multiplied by a fraction. The numerator of the fraction is the increase in the taxpayer's operating capacity for the taxable year. The denominator is the added operating capacity for the taxable year. Added operating capacity for the taxable year is determined for a taxpayer by adding together the seating capacities of the taxpayer's intercity buses included in operating capacity for the taxable year which were not included in operating capacity for the immediately preceding taxable year.

(iv) In the case of a partnership, each partner's qualified investment for the energy credit for a qualifying bus is the partner's qualified investment for the regular credit (determined under §1.46–3(f) multiplied by the fraction referred to in paragraph (q)(9)(iii) of this section for the partnership, as determined for the partnership taxable year in which the bus is placed in service.

(v) The following example illustrates this paragraph (q)(9):

Example. Corporation Y is a calendar year bus company that is an eligible taxpayer under paragraph (q)(2) of this section. Based upon the facts as set forth in the following table, Y makes the following calculations to determine the energy credit earned in 1981:

1. 1980 operating capacity determined as of 12/31/80:	
a. 5 intercity buses × 50 seats each	250
b. Total 1980 operating capacity	250
2. 1981 operating capacity determined as of 12/31/8:	
a. 2 1980 buses used on a full-time basis in 1981	100
b. 1981 added capacity:.	
i. Qualifying buses:	
Bus 1	45
Bus 2	55
Bus 3	50
ii. Intercity bus not a qualifying bus	50
iii. Total 1981 added capacity	200
c. Total 1981 operating capacity	300
3. 1981 increase in operating capacity (line 2c − line 1b)	50
4. Fraction for determining qualified investment attributable to increase in capacity (line 3 + line 2 (b)(iii))	¼

Accordingly, the energy credit earned in 1981 for each of the qualifying buses is determined as follows:

Qualified investment for the regular credit	×	Line 4	×	Energy percentage	=	Energy credit earned
Bus 1: $15,000		¼		10		$375
Bus 2: $20,000		¼		10		500
Bus 3: $25,000		¼		10		625
Total energy credit earned in 1981		....		....		1,500

(10) *Related taxpayers.* (i) Related taxpayers are treated as one taxpayer in determining the increase in operating capacity under paragraph (q)(9)(ii) of this section and in determining the qualified investment in qualified intercity buses for the energy credit under paragraph (q)(9)(iii) of this section. Related taxpayers are members of a group of trades or businesses that are under common control (as defined in §1.52–1(b)).

(ii) Related taxpayers make all computations relating to operating capacity on a group basis. Also, the determination of whether a bus meets the predominant use test is made on a group basis by aggregating bus usage by each member of the group. For example, if a bus is acquired by one member and used by that member for part of a taxable year and used by other members for the remainder, the combined usage is aggregated in determining whether the predominant use test is met. In addition, all related taxpayers are treated as one person in applying paragraph (q)(8) of this section (relating to leasing).

(iii) The energy credit earned for a qualifying bus is allocated to the member which acquired (or is a lessee treated under section 48(d) as having acquired) the bus whether or not that member had a separate increase in operating capacity for the taxable year.

(iv) Each member must make its own computation of the group's increase in operating capacity for the period comprising its taxable year. A member will make this computation as of the end of its taxable year ignoring different taxable years of other members. For the period comprising its taxable year, the member makes all calculations relating to group operating capacity, including the determination of full-time use by other members.

(v) Each member determines the composition of the group as of the end of that member's taxable year. For example, if X uses the calendar year and makes its computation as of December 31, 1981, and Y is a member of X's group at that time, Y's operating capacity determined as of the end of X's immediately preceding taxable year (December 31, 1980) is taken into account by X for 1980 even if Y was not a member of the group for any day prior to December 31, 1981.

(vi) The following example illustrates this paragraph (q)(10):

Example (a). Corporations X and Y are related taxpayers. In this example, each bus is a qualifying bus with a seating capacity of 50. Each bus owned at the close of either X's or Y's taxable year was used on a full-time basis for the relevant period corresponding to X's or Y's taxable year. Other facts are set forth in the following table:

	X	Y
Taxable year ends	Dec. 31	June 30.
Operating capacity for 1979.	5 buses	10 buses.
Buses added	3 buses Mar. 1, 1980.	3 buses May 15, 1981.
Buses sold	2 buses Mar. 31, 1981.	2 buses Sept. 30, 1980.
Cost of each added bus.	$40,000	$60,000.

(b) X makes the following calculations to determine the energy credit earned for calendar year 1980.

1. 1979 operating capacity determined as of 12/31/79:	
a. Attributable to X (5 buses × 50 seats)	250
b. Attributable to Y (10 buses × 50 seats)	500
c. Total 1979 operating capacity	750
2. 1980 operating capacity determined as of 12/31/80:	
a. X's 5 and Y's 8 1979 buses used on a full-time basis in 1980 and still owned on 12/31/80	650
b. 1980 added capacity (X's 3 buses × 50 seats)	150
c. Total 1980 operating capacity	800
3. 1980 increase in operating capacity (line 2c − line 1c)	50
4. Fraction in paragraph (q)(9)(iii) of this section (line 3 ÷ line 2b)	⅓

Accordingly, X earned an energy credit of $4,000 in 1980 ($40,000 × ⅓ × 10% × 3 buses).

(c) Since in calendar year 1981 X placed no qualifying buses in service, X earned no energy credit in 1981.

(d) Since in the taxable year 7/1/79–6/30/80 Y placed no qualifying buses in service, Y earned no energy credit in that taxable year.

(e) Y makes the following calculations to determine the energy credit earned in the taxable year 7/1/80–6/30/81.

1. Operating capacity for the taxable year ending 6/30/80 determined as of the close of that year:	
a. Attributable to X (8 buses × 50 seats)	400
b. Attributable to Y (10 buses × 50 seats)	500
c. Total operating capacity for that year	900
2. Operating capacity for the taxable year ending 6/30/81 determined as of the close of that year:	
a. X's 6 and Y's 8 buses from prior taxable year used on a full-time basis during current taxable year and still owned on 6/30/81	700
b. Capacity added during current taxable year (Y's 3 buses × 50 seats)	150
c. Total operating capacity for that year	850
3. Increase in operating capacity for taxable year ending 6/30/81 (line 2c − line 1c)	(50)

As determined for Y's taxable year ending 6/30/81 the group experienced a decrease in operating capacity. Thus, no energy credit is available for the buses Y placed in service in its taxable year ending 6/30/81.

(11) *Section 381(a) transactions.* (i) In the case of a transaction described in section 381(a), the operating capacity of each transferor or distributor corporation, determined as of the date of distribution or transfer (within the meaning of §1.381(b)–1(b)), shall reduce the operating capacity of the acquiring corporation (determined without this paragraph (q)(11)) for its first taxable year ending on or after that date for purposes of determining the acquiring corporation's energy credit for that year. This paragraph (q)(11) shall not apply to any case to which paragraph (q)(10) of this section (dealing with related taxpayers) applies.

(ii) The following example illustrates this paragraph (q)(11):

Example. X and Y are unrelated corporations which use the calendar year. For 1981, each has an operating capacity of 250 seats (5 buses × 50 seats). X merges into Y on January 1, 1982. On May 1, 1982, Y retires and sells two buses and acquires four 50-seat qualifying buses at a cost of $40,000 each. All buses owned by Y on December 31, 1982, are included in operating capacity. Y makes the following calculations to determine the energy credit earned in taxable year 1982.

1. Y's 1981 operating capacity determined as of 12/31/81	250
2.1982 operating capacity determined as of 12/31/82 without this paragraph (q)(11):	
a. X's 5 buses plus Y's 5 1981 buses less 2 retired buses (8 buses × 50 seats)	400
b. 1982 added capacity (4 buses × 50 seats)	200
c. Total	600
3. Operating capacity of transferor (X) on 1/1/82	250
4. Y's 1982 operating capacity (line 2c − line 3)	350
5. 1982 increase in operating capacity (line 4 − line 1)	100
6. Fraction in paragraph (q)(9)(iii) of this section (line 5 ÷ line 2b)	½

7. Energy credit earned in 1982 ($40,000 × ½ × 10% × 4 buses) $8,000

(Secs. 7805 (68A Stat. 917, 26 U.S.C. 7805) and 38 (b) (76 Stat. 962, 26 U.S.C. 38) of the Internal Revenue Code of 1954; secs. 38(b) (76 Stat. 963, 26 U.S.C. 38(b)), 48(l)(16) (94 Stat. 264, 26 U.S.C. 48(l)(16)), and 7805 (68A Stat. 917, 26 U.S.C. 7805))

[T.D. 7291, 46 FR 7291, Jan. 23, 1981, as amended by T.D. 7982, 49 FR 39542, Oct. 9, 1984; 49 FR 41246, Oct. 22, 1984; T.D. 8014, 50 FR 11853, Mar. 26, 1985; T.D. 8147, 52 FR 27337, July 21, 1987]

§ 1.48–10 Single purpose agricultural or horticultural structures.

(a) *In general*—(1) *Scope.* Under section 48(a)(1)(D), ‘‘section 38 property’’ includes single purpose agricultural and horticultural structures, as defined in section 48 (p) and paragraphs (b) and (c) of this section. These structures are subject to a special rule for recapture of the credit. See paragraph (g) of this section. For the relation of this section to section 48(a)(1)(B) (other tangible property) and to sections 1245 and 1250 (depreciation recapture), see paragraph (h) of this section.

(2) *Effective date.* The provisions of section 48(a)(1)(D) and this section apply to open taxable years ending after August 15, 1971.

(b) *Definition of single purpose agricultural structure*—(1) *In general.* Under section 48(p)(2), a single purpose agricultural structure is any structure or enclosure that meets all of the following requirements:

(i) It is specifically designed and constructed for permissible purposes (as defined in paragraph (b)(2) of this section). See paragraph (d) of this section for the rule regarding ‘‘specifically designed and constructed’’.

(ii) It is specifically used exclusively for those permissible purposes. See paragraph (e) of this section for the rules regarding ‘‘specifically used’’.

(iii) It houses equipment necessary to house, raise, and feed livestock and their produce. See paragraphs (b)(3) and (4) of this section.

(2) *Permissible purposes.* The following are the only permissible purposes for a single purpose agricultural structure:

(i) Housing, raising, and feeding a particular type of livestock and, at the taxpayer's option, its produce. The term ‘‘housing, raising, and feeding’’ includes the full range of livestock breeding and raising activities, including ancillary post-production activities (as defined in paragraph (f) of this section). Thus, for example, use of a structure for breeding livestock, or for producing eggs or livestock, is permitted. The structure may also be used for storing feed or machinery, but more than strictly incidental use for these purposes will disqualify the structure. See paragraph (e)(1) of this section. For the special rule concerning the permissible purposes for a milking parlor, see paragraph (b)(2)(iii) of this section.

(ii) Housing required equipment (including any replacements) as defined in paragraph (b)(4) of this section.

(iii) If the structure is a dairy facility, it will qualify if it is used for: (A) activities consisting of the production of milk or of the production of milk and the housing, raising, or feeding dairy cattle, and (B) housing equipment (including any replacements) necessary for these activities. The term ‘‘housing, raising, or feeding’’ includes the full range of dairy cattle breeding and raising activities including ancillary post-production activities (as defined in paragraph (f) of this section). The structure may also be used for storing feed or machinery, but, more than incidental use for these purposes will disqualify the structure. See paragraph (e)(1) of this section.

(3) *Livestock; particular type of livestock*—(i) *Livestock.* Livestock qualifying as ‘‘section 38 property’’ under § 1.48–1(l) constitutes livestock for purposes of this section. Thus, for example, horses are not livestock for purposes of this section since they do not qualify as ‘‘section 38 property’’ under § 1.48–1(l). Under section 48(p)(6) poultry constitutes livestock for purposes of section 48(a)(1)(D). The term ‘‘livestock’’ includes the offspring of livestock. ‘‘Livestock’’ is distinguished from the produce of livestock, such as milk and eggs held for sale. For purposes of this section, eggs held for hatching and newborn livestock are considered livestock. A structure used solely to house produce of livestock or equipment necessary to house produce of livestock will not qualify as a single purpose agricultural structure. Thus,

for example, a dairy facility used solely for storing milk will not qualify.

(ii) *Particular type of livestock.* A structure qualifies as a single purpose agricultural structure only if it is specifically designed, constructed, and used exclusively for permissible purposes with respect to one particular type of livestock. For purposes of this section, each species is a different type except that all species of poultry are considered to be of a single type. Thus, for example, a structure specifically designed and constructed as a single purpose hog-raising facility will not qualify if it is used to raise dairy cows, but a structure specifically designed, constructed, and used to raise poultry may house, raise, and feed both chickens and turkeys.

(4) *Required equipment rule.* (i) A single purpose agricultural structure must also house equipment necessary to house, raise, and feed the livestock (''required equipment''). Required equipment must be an integral part of the structure, and includes, but is not limited to, equipment necessary to contain the livestock, to provide them with water or feed, and to control the temperature, lighting, and humidity of the interior of the structure. For purposes of this section, equipment is an integral part of the structure if it is physically attached to or a part of the structure. The useful life of the structure, however, need not be contemporaneous with the life of the equipment it houses. A structure without required equipment is not a single purpose agricultural structure.

(ii) A single purpose agricultural structure may, but is not required to, house equipment (for example, loading chutes) necessary to the conduct of ancillary post-production activities as defined in paragraph (f) of this section.

(5) *Livestock structure.* In section 48(p)(2), the terms ''single purpose livestock structure'' and ''single purpose agricultural structure'' are interchangeable.

(c) *Definition of single purpose horticultural structure*—(1) *In general.* Under section 48(p)(3), a single purpose horticultural structure is any structure that meets both of the following requirements:

(i) It is a greenhouse or other structure specifically designed and constructed for permissible purposes (as defined in paragraph (c)(2) of this section). See paragraph (d) of this section for the rule regarding ''specifically designed and constructed.''

(ii) It is specifically used exclusively for those permissible purposes. See paragraph (e) of this section for the rules regarding ''specifically used.''

(2) *Permissible purposes.* The following are the only permissible purposes for a single purpose horticultural structure:

(i) The commercial production of plants (including plant products such as flowers, vegetables, or fruit) in a greenhouse.

(ii) The commercial production of mushrooms.

(iii) A single purpose horticultural structure also may, but is not required to, house equipment necessary to carry out these permissible purposes listed in paragraphs (c)(2) (i) and (ii) of this section.

(3) *Ancillary post-production activities.* The terms ''commercial production of plants'' and ''commercial production of mushrooms'' include ancillary post-production activities (as defined in paragraph (f) of this section).

(d) *Specifically designed and constructed.* A structure is specifically designed and constructed if it is not economic to design and construct the structure for the intended qualifying purpose and then use the structure for a different purpose. For example, if a hog raising structure is designed and constructed in accordance with a standard set of plans for such a structure provided by the Department of Agriculture, it would not be economic to use the structure for purposes other than hog raising.

(e) *Specifically used.* There are two aspects of the specific use requirement—exclusive use and actual use.

(1) *Exclusive use.* (i) A structure qualifies as a single purpose agricultural or horticultural structure only if it is used exclusively for the permitted purposes by reason of which it qualified for the credit. Thus—

(A) The structure may not be used for any nonpermissible purposes (for example, processing, marketing, or more than incidental use for storing feed or equipment) and

(B) It may not be put to any use other than the specific use by reason of which it qualifies for the credit.

(ii) For purposes of this section, the term ''incidental use'' means a use which is both related and subordinate to the qualifying purpose. Thus, for example, if feed is stored in an agricultural structure which will be used for raising hogs, the feed must be used only for the hogs in order to be related to the qualifying purpose. In determining whether use of the structure for feed storage is subordinate to the qualifying purpose, all of the facts and circumstances must be considered, including, with respect to feed storage, the following:

(A) Type of animal involved;

(B) Number of, and consumption rate for, each animal;

(C) Climate of area;

(D) Total volume of storage area; and

(E) Percentage of structure's total volume devoted to storage.

(iii) It will be presumed that the storage function is not subordinate to the qualifying purpose of the structure if more than one-third of the structure's total usable volume is devoted to storage. This presumption may be rebutted with clear and convincing evidence.

(iv) A structure may fail the exclusive use test if either of the requirements of paragraph (e)(1)(i) of this section is not met. Thus, for example, a horticultural structure that contains an area for processing plants or plant products will fail the exclusive use test because there is a nonpermissible use. An agricultural structure that is used to house more than one particular type of livestock fails the exclusive use test for the same reason. A change in the use of an agricultural structure from one species of livestock to another will cause the structure to fail the exclusive use test when the change occurs. Thus, for example, a hog-raising facility which qualified for the credit when it was placed in service cannot later be modified and used for producing broiler chickens even if the structure would have qualified for the credit if it had been originally designed, constructed, and used exclusively for producing broiler chickens.

(2) *Actual use.* (i) A single purpose agricultural or horticultural structure also must actually be used for the permissible purpose by reason of which it qualifies for the credit. ''Actual use'' means ''placed in service'' (as defined in §1.46–3(d)). Mere vacancy, on a temporary basis, will not disqualify the structure. Thus, for example, a structure that is designed and constructed as a hog-raising structure will not qualify if it is never placed in service for raising hogs. However, a turkey-raising facility will not be disqualified if the turkeys are all sent to a packing plant in November and the structure remains vacant until the next spring when newly hatched turkeys are placed in the structure to be raised.

(ii) For purposes of this section, ''vacancy on a temporary basis'' includes temporary vacancy caused by market fluctuations or other economic considerations and vacancy on a seasonal basis.

(f) *Work space; ancillary post-production activities*—(1) *Permissible work space.* Under section 48(p)(4), a single purpose agricultural or horticultural structure may contain work space only if it is used for—

(i) Stocking, caring for, or collecting livestock, plants, or mushrooms,

(ii) Maintenance of the structure, or

(iii) Maintenance or replacement of the equipment or stock enclosed by or contained in the structure. Thus, for example, an eligible structure may not contain space devoted to processing or marketing or other nonpermissible purposes.

(2) *Ancillary post-production activities.* The term ''stocking, caring for, or collecting'' the livestock, plants, or mushrooms includes ancillary post-production activities. These activities, therefore, constitute permissible purposes when carried on in conjunction with other permissible purposes, and a qualifying structure may contain work space devoted to such activities. Ancillary post-production activities include gathering, sorting, and loading livestock, plants, and mushrooms and packing unprocessed plants, mushrooms, and the live offspring and unprocessed produce of the livestock. Ancillary post-production activities do not include processing activities, such

as slaughtering or packing meat, nor do they include marketing activities.

(g) *Special rule for recapture under section 47.* Under section 48(p)(5), if a structure which qualifies for the credit under this section becomes ineligible because it ceases to be held for the specific use by reason of which it qualified (or it is used for other than that qualifying use) before the end of the applicable estimated useful life or period specified in section 47(a), then the investment credit previously allowed with respect to the structure may be partially or entirely recaptured under section 47. Unlike other property to which section 47 applies, single purpose structures may not be converted from one permissible use to another without recapture. See subparagraph (e)(2) of this section.

(h) *Relationship to other sections*—(1) *Relation to section 48(a)(1)(B).* All structures satisfying the requirements of section 48(a)(1)(B) and (a)(1)(D) will be considered to qualify under either provision.

(2) *Relationship to sections 1245 and 1250.* For purposes of depreciation recapture, property to which section 48(a)(1)(D) applies is section 1245 property, except that property placed in service prior to January 1, 1981, may, at the option of the taxpayer, be treated as section 1250 property if depreciation deductions allowed were not under one of the methods authorized only for section 1245 property.

(i) [Reserved]

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

Example 1. A constructs a rectangular structure for use as an egg-producing facility. The structure has no windows. The walls and roof are made of corrugated steel and there is a door which is 4 feet wide and 8 feet tall at each end of the structure. At the end of each wall are louvered openings approximately 4 feet high and 8 feet long. These openings house thermostatically controlled fans. In the center of the walls are manually operated fresh-air openings. Corrugated steel ''curtains'' hang from the top of the openings so that the openings can be completely closed in cold weather, but the curtains can be propped open to admit fresh air. The building is well insulated. A has reinforced the roof with extra trusses and rafters and reinforced the building with extra wall studs. Two rows of cages are suspended from the rafters by thin steel girders and wires. The floor of the structure is a sloping concrete slab pierced with long troughs which run the length of the structure beneath the cages. The troughs are used for collection and disposal of chicken wastes. When this structure is placed in service it will qualify for an investment credit under this section.

Example 2. B constructs a greenhouse for the commercial production of plants. The greenhouse is a rectangular structure with translucent fiberglass walls and roof. The structure is equipped with an automatic temperature and humidity control system. Pipes were installed to carry water and liquid fertilizer to the plants and to release minute amounts of carbon dioxide into the air. When the structure was originally placed in service B used the entire structure for growing flowers commercially. In September 1978, B began to use the structure for growing tomatoes. Because of the success of the venture, in January 1979, B began to use the entire structure for growing tomatoes. In February 1980, B set up a small counter with a cash register at one end of the structure so that workers could sell tomatoes to customers at the greenhouse. Until February 1980, the structure would qualify for the credit under this section. The change in use from growing flowers to growing tomatoes will not affect the eligibility of the structure. Once the cash register is installed, however, the structure fails to meet both the exclusive use test of paragraph (e)(1) of this section and the work space rule of paragraph (f) of this section since a single purpose structure may not be used for marketing activities.

Example 3. C purchases a prefabricated structure and makes modifications so that the structure will meet C's requirements. C adds gates and constructs a partition which divides the structure into two parts. One part of the structure constitutes less than one-third of the total usable volume of the structure and is used to house feeder cattle while they are fed with hay. This part of the structure has a sloping concrete floor. The other part of the structure constitutes more than two-thirds of the total usable volume of the structure and is used to store the hay used to feed the cattle. This structure will not qualify for the credit since it fails the required equipment test. The structure does not contain equipment which is an integral part of the structure. This structure also fails the ''specifically designed and constructed'' test of paragraph (d) of this section since it would be economic to use the structure for purposes other than housing, raising, and feeding cattle (such as a general purpose barn, for example). Finally, the structure fails the incidental use test of paragraph (e) of this section because the storage function is presumptively not subordinate to the qualifying purpose since more than two-thirds of the structure's total usable volume is devoted to storage and none of the facts will serve to rebut the presumption.

(Secs. 7805 (68A Stat. 917, 26 U.S.C. 7805) and 38 (b) (76 Stat. 926, 26 U.S.C. 38))

[T.D. 7900, 48 FR 32768, July 19, 1983; 48 FR 36448, Aug. 11, 1983]

§ 1.48–11 Qualified rehabilitated building; expenditures incurred before January 1, 1982.

(a) *In general.* Under section 48(a)(1)(E), that portion of the basis of a qualified rehabilitated building which is attributable to qualified rehabilitation expenditures qualifies as section 38 property. In general, property which is treated as section 38 property by reason of section 48(a)(1)(E) is treated as new section 38 property and therefore is not subject to the used property limitation. See § 1.48–2(d). Section 48(g)(1) and paragraph (b) of this section define the term ''qualified rehabilitated building''. Section 48(g)(2) and paragraph (c) of this section define the term ''qualified rehabilitation expenditure''. Paragraph (d) of this section provides guidance for coordination of these provisions with other sections of the Code.

(b) *Definition of qualified rehabilitated building*—(1) *In general.* The term ''qualified rehabilitated building'' means any building and its structural components—

(i) Which has been rehabilitated (within the meaning of paragraph (b)(3) of this section),

(ii) Which was placed in service (within the meaning of § 1.46–3(d)) by any person at any time before the beginning of the rehabilitation,

(iii) 75 percent or more of the existing external walls of which are retained in place as external walls (within the meaning of paragraph (b)(4) of this section) in the rehabilitation process, and

(iv) Which meets the twenty-year requirement in paragraph (b)(2) of this section.

In addition, a major portion of a building may be treated as a separate building for purposes of this paragraph if the requirements of paragraph (b)(5) of this section are met.

(2) *Twenty-year requirement*—(i) *In general.* A building is considered a qualified rehabilitated building only if a period of at least 20 years has elapsed between the date physical work on the rehabilitation of the building began, and the later of—

(A) The date the building was first placed in service (see § 1.46–3(d)) by any person as a building, or

(B) The date the building was placed in service by any taxpayer in connection with a prior rehabilitation with respect to which a credit was allowed by reason of section 48(a)(1)(E).

(ii) *Vacant periods.* The 20-year period includes periods during which a building was vacant or devoted to a personal use and is computed without regard to the number of owners or the identity of owners during the period.

(iii) *Physical work on a rehabilitation.* For purposes of this section, ''physical work on a rehabilitation'' begins when actual construction begins. The term ''physical work on a rehabilitation'' does not include preliminary activities such as planning, designing, securing financing, exploring, researching, developing plans and specifications, or stabilizing a building to prevent deterioration (e.g., placing boards over broken windows).

(iv) *Special rule.* If a part of a building meets the twenty-years requirement in subdivision (i) of this subparagraph and a part (for example, an addition) does not, a rehabilitation of that part that meets the requirement may qualify for a credit only if that part constitutes a major portion (as defined in paragraph (b)(5) of this section) of the building.

(3) *Rehabilitation*—(i) *In general.* For purposes of this paragraph, rehabilitation includes renovation, restoration, or reconstruction. However, the term ''rehabilitation'' does not include enlargement (within the meaning of paragraph (c)(7)(ii) of this section), new construction, or the completion of new construction after a building has been placed in service. For purposes of this paragraph (b)(3), whether expenditures are attributable to the rehabilitation of an existing building, or to new construction, is determined upon all the facts and circumstances.

(ii) *Substantial rehabilitation.* For a building to be considered rehabilitated, the rehabilitation must be substantial. Whether a rehabilitation is substantial is determined upon the basis of all the facts and circumstances. In general, to be substantial, the rehabilitation must do one of the following:

(A) Materially extend the useful life of the building;

(B) Significantly upgrade its usefulness (for either the same or a new use); or

(C) Preserve it in a way that significantly improves its condition or enhances its historic value.

A substantial rehabilitation may vary in degree from gutting and extensive reconstruction of a building's major structural components to the cure of a substantial accumulation of major disrepairs. It may also include renovation, alteration, or remodelling for the conversion of a structurally sound building to a design and condition required for a new use. Cosmetic improvements alone, however, do not qualify as a substantial rehabilitation.

(iii) *Aggregation of rehabilitation.* In the case where qualified rehabilitation expenditures are incurred with respect to a rehabilitation of a building by more than one person (e.g., a lessor and a lessee, several lessees, or several condominium owners), the substantial rehabilitation requirement in this paragraph (b)(3) shall be applied by aggregating all the rehabilitation work done by such persons.

(iv) *Special rule by qualified rehabilitation expenditures treated as incurred by the taxpayer.* In the case where qualified rehabilitation expenditures are treated as having been incurred by a taxpayer because of the application of paragraph (c)(3)(ii) of this section, the substantial rehabilitation test in paragraph (b)(3)(ii) of this section will be applied by aggregating the rehabilitation work done by the transferor and the transferee.

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

Example 1. Taxpayer A is the owner of a 30-year old building. The building is air conditioned by means of window air conditioning units. A replaces the window units with a central air conditioning system and no other rehabilitation is performed by A. The expenditures incurred by A did not materially extend the building's useful life, significantly upgrade its usefulness, or preserve it in a manner that significantly improves its condition or enhances its historic value. Although expenditures for replacement of window units with a central air conditioning system may constitute qualified expenditures as part of an overall rehabilitation, alone they do not qualify as a substantial rehabilitation and the building is not considered rehabilitated within the meaning of this subparagraph.

Example 2. Taxpayer B is the owner of a 10 story office building that is 35 years old. The building is in substantial disrepair and in order to modernize it as an office building B installs new plumbing, electrical wiring, and heating and air conditioning systems. In addition, the layout of each floor is changed by means of tearing down many existing interior walls and partitions and building new walls, partitions, and doors. Old plaster is removed from many walls and replaced by new wall covering. New windows and new flooring are installed throughout the building. The improvements made by B materially extend the useful life of the building and significantly upgrade its usefulness. The building is considered rehabilitated within the meaning of the facts and circumstances test in this subparagraph.

Example 3. Taxpayer C is the owner of a 100-year old building that has substantial historic character, although the building is not a certified historic structure (as defined in section 191(d)(1) and the regulations thereunder). C uncovers and restores the original woodwork, wall coverings and moldings throughout the building. The windows and doors are replaced with replicas of the original. The improvements made by C significantly preserve the building and significantly enhance its historic value. Thus, the building is considered rehabilitated within the meaning of this subparagraph.

(4) *Retention of 75 percent of external walls*—(i) *In general.* A building meets the requirements set forth in paragraph (b)(1)(iii) only if 75 percent or more of the existing external walls (as measured by the total area of the existing external walls) are retained in place as external walls in the rehabilitation process. For this purpose, the area of existing external walls includes the area of windows and doors.

(ii) *External wall.* For purposes of this paragraph (b)(4), a wall includes both the supporting elements of the wall and the nonsupporting elements (e.g., a curtain) of the wall. Except as otherwise provided in this paragraph (b)(4), the term ''external wall'' includes any wall that has one face exposed to the weather, earth, or an abutting wall erected on an adjacent property. An external wall also includes a shared wall (*i.e.*, a single wall shared with an adjacent building), generally referred to as a ''party wall''.

(iii) *Alternative rule.* Notwithstanding the definition of external wall contained in paragraph (b)(4)(ii) of this section, in any case in which the building being rehabilitated would fail to meet the requirements of a qualified rehabilitation building if the definition of external wall in paragraph (b)(4)(ii) of this section were used, then the term ''external wall'' shall be defined as a wall, including its supporting elements, with one face exposed to the weather or earth, and a common wall shall not be treated as an external wall.

(iv) *Retained in place.* An existing external wall is retained in place if the supporting elements of the wall are retained in place. An existing external wall is not retained in place if the supporting elements of the wall are replaced by new supporting elements. An external wall is retained in place, however, if the supporting elements are reinforced in the rehabilitation, provided that such supporting elements of the external wall are retained in place. An external wall is retained in place even though it is covered (e.g., with new siding). Moreover, the existing curtain may be replaced with a new curtain provided that the structural framework that provides for the support of the existing curtain is retained in place. An external wall is retained in place notwithstanding that the existing doors and windows in the wall are modified, eliminated, or replaced. A wall may be disassembled and reassembled so long as the same supporting elements are used when the wall is reassembled. Thus, for example, in the case of the brick wall, the wall is considered retained in place even though the original bricks are removed (for cleaning, etc.) and put back to form the wall.

(v) *Retention as an external wall.* For purposes of meeting the 75 percent requirement of this subparagraph (4), an existing external wall must be retained in place as an external wall. If an addition is made that results in an existing external wall being converted into an internal wall, the wall is not retained in place as an external wall.

(vi) *Special rule.* Solely for the purpose of meeting the 75 percent requirement of this subparagraph (4), the walls of an uncovered internal shaft designed solely to bring light or air into the center of a building which are completely surrounded by external walls of the building and which enclose space not designated for occupancy or other use by people (other than for maintenance or emergency) are not considered external walls. Thus, a wall of a light well in the center of an office building is not an external wall. However, walls surrounding an uncovered courtyard which is usable by the building's occupants, (e.g., at lunch time) are external walls.

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

Example 1. Taxpayer A rehabilitated a building all of the walls of which consisted of wood siding attached to gypsum board sheets (which covered the studs). A covered the existing wood siding with aluminum siding in a part of a rehabilitation that otherwise qualified under this subparagraph. A satisfied the requirement that 75 percent of the existing external walls must be retained in place as external walls.

Example 2. Taxpayer B rehabilitated a building the external walls of which had a masonry curtain. The masonry on the wall face was replaced with a glass curtain. The steel beam and girders supporting the existing curtain were retained in place. B satisfied the requirement that 75 percent of the existing external walls must be retained in place as external walls.

Example 3. Taxpayer C rehabilitated a building which has two external walls measuring 75′ × 20′ and two other external walls measuring 100′ × 20′. C tore down one of the larger walls, including its supporting elements, which accounted for more than 25% of the building's external walls and constructed a new wall. C has not satisfied the requirement that 75 percent of the existing external walls must be retained in place as external walls.

Example 4. The facts are the same as in example 3, except C does not tear down any walls, but makes an addition that results in one of the smaller walls becoming an internal wall. In addition, C enlarged 8 of the existing windows on the larger walls, increasing them from a size of 3′ × 4′ to 6′ × 8′. Since the smaller wall accounts for less than 25 percent of the total wall area, C has satisfied the requirement that 75 percent of the existing external walls must be retained in place as external walls in the rehabilitation process. The enlargement of the existing windows on the larger wall does not change the result.

(5) *Major portion treated as separate building*—(i) *In general.* Where there is a separate rehabilitation of a major portion of a building, such major portion shall be treated as a separate building. Thus, such major portion may qualify as a qualified rehabilitated building if the requirements of this paragraph are met with respect to such major portion. Expenditures for property that services both a major portion of a building and another portion must be specifically allocated to each portion to the extent possible. If it is not possible to make such an allocation, the expenditures must be allocated to each portion on some reasonable basis. What constitutes a reasonable basis for an allocation depends on factors such as the type of improvement and how the improvement relates functionally to the building. For example, in the case of expenditures for an air conditioning system or a roof, a reasonable basis for allocating the expenditures would be the volume of the major portion served by the improvement relative to the volume of the other portion of the building served by the improvement.

(ii) *Major portion defined.* Whether a part of a building constitutes a major portion of the building is determined upon the basis of all the facts and circumstances. A major portion must generally consist of clearly identifiable parts of a building (e.g., a wing of a building or the first 5 stories of a 7 story building). The following factors shall be taken into account:

(A) Whether the portion comprises an entire leasehold interest or an entire ownership (e.g., condominium) interest;

(B) Whether the portion (as measured by volume) is sufficiently large that it would be reasonable to treat it as a separate building; and

(C) Whether the portion is functionally different from other parts of the building.

(6) *Special rule for rehabilitation done in phases.* If rehabilitation which is not continuous is determined under this subparagraph to be a single rehabilitation done in phases, the requirements of this paragraph (b) are to be applied with respect to the overall rehabilitation and not merely to a phase of the rehabilitation. In such case, a phase of a single overall rehabilitation will not be considered as ''prior rehabilitation'' for purposes of subparagraph (2)(i)(B) of this paragraph (b). Whether rehabilitation which is not continuous is a single rehabilitation that is done in phases is determined on the basis of all the facts and circumstances. Generally, however, to constitute a single rehabilitation that is done in phases, there must exist, prior to the time any rehabilitation work is commenced, a set of written plans describing generally all phases of the rehabilitation of the building and a reasonable expectation that all phases of the rehabilitation will be completed. Such written plans are not required to contain detailed working drawings or detailed specifications of the material to be used. In addition, the period between the time that physical work on the first phase of the overall rehabilitation begins and physical work on the last phase of the overall rehabilitation begins must be reasonable. In determining whether the rehabilitation is completed within a reasonable time, the fact that a building is occupied during the rehabilitation, the necessity of acquiring a lease (of additional portions of the building), and unforeseen delays shall be taken into account. Other factors that are relevant in determining whether rehabilitation is a single rehabilitation include the length of time between each phase of rehabilitation activities and the extent of rehabilitation activity in each phase.

(7) *Special rule for adjoining buildings that are combined.* For purposes of this paragraph (b), if as part of a rehabilitation process two or more adjoining buildings are combined and placed in service as a single building after the rehabilitation process, then all of the requirements of a qualified rehabilitated building in section 48(g)(1) and this section may be applied to the constituent adjoining buildings in the aggregate. Any party walls or abutting walls between the constitutent buildings that would otherwise be treated as external

walls (within the meaning of paragraph (b)(4)(ii) of this section) would not be treated as external walls of the building; the substantial rehabilitation test in paragraph (b)(3)(ii) of this section would be applied to the aggregate rehabilitation work with respect to all of the constitutent buildings.

(c) *Definition of qualified rehabilitation expenditures*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, the term "qualified rehabilitation expenditure" means any amount—

(i) Properly chargeable to capital account (as described in subparagraph (2) of this paragraph),

(ii) Incurred after October 31, 1978, for depreciable or amortizable property (or additions or improvements to property) with a useful life of five years or more, and

(iii) Made in connection with the rehabilitation of a qualified rehabilitated building.

(2) *Chargeable to capital account.* For purposes of paragraph (c)(1)(i) of this section, amounts paid or incurred are chargeable to capital account if under the taxpayer's method of accounting they are property includible in computing basis under §1.46–3. Amounts treated as an expense and deducted in the year they are paid or incurred are not chargeable to capital account.

(3) *Incurred by the taxpayer*—(i) *In general.* Generally, to qualify for a credit under section 48 (a)(1)(E), qualified rehabilitation expenditures must be incurred by the taxpayer after October 31, 1978. An expenditure is incurred for purposes of this paragraph on the date such expenditure would be considered incurred under the accrual method of accounting, regardless of the method of accounting used by the taxpayer with respect to other items of income and expense. If qualified rehabilitation expenditures are treated as having been incurred by a taxpayer under paragraph (c)(3)(ii)) of this section, the taxpayer shall be treated as having incurred the expenditures on the date such expenditures were incurred by the transferor.

(ii) *Qualified rehabilitation expenditures treated as incurred by the taxpayer.* (A) Where rehabilitation expenditures are incurred with respect to a building by a person (or persons) other than the taxpayer and the taxpayer acquires the building, or a portion of the building to which the expenditures are allocable, the taxpayer acquiring such property will be treated as having incurred the rehabilitation expenditures actually incurred by the transferor (or treated as incurred by the transferor under this paragraph (c)(3)(ii)) with respect to the acquired property, provided that—

(*1*) The building, or the portion of the building, acquired by the taxpayer was not used after the rehabilitation expenditures were incurred and prior to the date of acquisition by the taxpayer, and

(*2*) No credit with respect to such qualified rehabilitation expenditures is claimed by anyone other than the taxpayer acquiring the property.

For purposes of this paragraph (c)(3)(ii), use shall mean actual use, whether personal or business.

(B) The amount of qualified rehabilitation expenditures treated as incurred by the taxpayer under this paragraph is the lesser of—

(*1*) The qualified rehabilitation expenditures incurred before the date on which the taxpayer acquired the building (or portion thereof), to which the expenditures are attributable, or

(*2*) That portion of the taxpayer's cost or other basis for the property which is attributable to the qualified rehabilitation expenditures described in paragraph (c)(3)(B)(*1*) of this section incurred before such date.

For purposes of paragraph (c)(6)(ii) of this section, the amount of rehabilitation expenditures treated as incurred by the taxpayer under this paragraph (c)(3)(ii) shall not be considered to be part of the cost of acquiring a building or any interest in the building. The portion of the cost of acquiring a building (or an interest therein) which is not treated under this paragraph as qualified rehabilitation expenditures incurred by the taxpayer is not eligible for a rehabilitation investment credit. See paragraph (c)(6)(ii) of this section.

(C) See paragraph (b)(2)(iv) of this section for rules concerning the application of the substantial rehabilitation test to expenditures treated as incurred by the taxpayer.

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

Example 1. In 1978, taxpayer A, a cash basis taxpayer, commenced the rehabilitation of a 30-year old building. In June 1978, A signed contract with a plumbing contractor for replacement of the plumbing in the building. A agreed to pay the contractor as soon as the work was completed. The work was completed in September 1978, but A did not pay the amount due until November 1, 1978. The expenditures for the plumbing are not qualified rehabilitation expenditures because they were not incurred after October 31, 1978.

Example 2. B incurred qualified rehabilitation expenditures of $300,000 with respect to an existing building between January 1, 1980, and May 15, 1980, and then sold the building to C on June 1, 1980. If the property attributable to the expenditures was not placed in service by A during the period from January 1, 1980, to June 1, 1980, C will be treated as having incurred the expenditures.

(4) *Incurred for 5-year property.* An expenditure is incurred for depreciable or amortizable property if the amount of the expenditure is added to the basis of property which is depreciable or amortizable under section 167. The determination of whether property has a useful life of five years or more is made by applying the principles of §1.46–3(e). In the case of expenditures for property made by a lessee, see sections 167 and 178 and the regulations thereunder for rules relating to whether improvements made to leased property are depreciable or amortizable.

(5) *Made in connection with the rehabilitation of a qualified rehabilitated building.* Expenditures attributable to work done to facilities related to a building (e.g., sidewalk, parking lot, landscaping) are not considered made in connection with a rehabilitation of a qualified rehabilitated building.

(6) *Certain expenditures excluded from qualified rehabilitation expenditures.* The term ''qualified rehabilitation expenditures'' does not include the following expenditures:

(i) An expenditure for property which is ''section 38 property'' (determined without regard to section 48(a)(1) (E) and (l)).

(ii) The cost of acquiring a building or any interest in a building (including a leasehold interest) except as provided in paragraph (c)(3)(ii) of this section.

(iii) An expenditure attributable to enlargement of a building (as defined in paragraph (c)(7) of this section).

(iv) An expenditure attributable to rehabilitation of a certified historic structure (as defined in section 191(d)(1) and the regulations thereunder), unless the rehabilitation is a certified rehabilitation (as defined in paragraph (c)(8) of this section).

(7) *Expenditures for enlargement distinguished*—(i) *In general.* Expenditures attributable to an enlargement of an existing building do not qualify as qualified rehabilitated expenditures. A building is enlarged to the extent that the total volume of the building is increased. An increase in floor space resulting from interior remodeling is not considred an enlargement. Generally, the total volume of a building is equal to the product of the floor area of the base of the building and the height from the underside of the lowest floor (including the basement) to the average height of the finished roof (as it exists or existed). For this purpose, floor area is measured from the exterior faces of external walls (other than shared walls that are external walls) and from the centerline of shared walls that are external walls. In addition, a building is enlarged to the extent of any construction outside the exterior faces of the existing external wall of the building.

(ii) *Rehabilitation which includes enlargement.* If expenditures for property only partially qualify as qualified rehabilitation expenditures because some of the expenditures are also attributable to the enlargement of the building, the expenditures must be apportioned between the original portion of the building and the enlargement. This allocation should be made using the principles contained in paragraph (b)(5)(i) of this section.

(8) *Certified rehabilitation*—(i) *In general.* For the purpose of this paragraph (c) of this section, the term ''certified rehabilitation'' means any rehabilitation of a certified historic building in a registered historic district which the Secretary of the Interior has certified to the Secretary as being consistent with the historic character of such building or the district in which such building is located.

(ii) *Revoked or invalidated certifications.* If the Department of Interior revokes or otherwise invalidates a certification after it has been provided to a taxpayer, the decertified property will cease to be section 38 property described in section 48(a)(1)(e). Such cessation shall be effective as of the date the activity giving rise to the revocation or invalidation occurred. See section 47 for the rules applicable to property that ceases to be section 38 property.

(d) *Coordination with other provisions of the Code*—(1) *Credit by lessees*—(i) *Rehabilitation performed by lessor.* A lessee may take the credit for rehabilitation performed by the lessor if the requirements of this section and section 48(d) are satisfied. For purposes of applying section 48(d), the fair market value of section 38 property described in section 48(a)(1)(E) shall be equal to that portion of the lessor's basis in a qualified rehabilitated building that is attributable to qualified rehabilitation expenditures.

(ii) *Rehabilitation performed by lessee.* A lessee may take the credit for rehabilitation performed by the lessee, provided that the property (or improvements or additions to property) for which the rehabilitation expenditures are made is depreciable (or amortizable) by the lessee (see sections 167 and 178, and the regulations thereunder) and the requirements of this section are satisfied.

(2) *When credit may be claimed.* The investment credit for qualified rehabilitation expenditures is allowed generally in the taxable year in which the property to which the rehabilitation expenditures is attributable is placed in service, provided the building is a qualified rehabilitated building for the taxable year. See §1.46–3(d). Under certain circumstances, however, the credit may be available prior to the date the property is placed in service. See section 46(d) and §1.46–5 (relating to qualified progress expenditures).

(3) *Recapture.* If property described in section 48(a)(1)(E) is disposed of by the taxpayer, or otherwise ceases to be ''section 38 property,'' recapture may result under section 47. Property will cease to be section 38 property, and therefore recapture may occur under section 47, in any case where the Department of Interior revokes or otherwise invalidates a certification of rehabilitation (see section 48(g)(2)(C)) after the property is placed in service because, for example, the taxpayer made modifications to the building inconsistent with Department of Interior standards.

(e) *Effective date*—(1) *General rule.* Except as provided in paragraph (e)(2) of this section, this §1.48–11 shall not apply to expenditures incurred after December 31, 1981.

(2) *Transitional rule.* This §1.48–11 shall continue to apply to expenditures incurred after December 31, 1981, for the rehabilitation of a building if—

(i) The physical work on the rehabilitation began before January 1, 1982, and

(ii) The building does not meet the requirements of section 48(g)(1) of the Code as amended by the Economic Recovery Tax Act of 1981.

[T.D. 8031, 50 FR 26698, June 28, 1985]

§1.48–12 Qualified rehabilitated building; expenditures incurred after December 31, 1981.

(a) *General rule*—(1) *In general.* Under section 48(a)(1)(E), the portion of the basis of a qualified rehabilitated building that is attributable to qualified rehabilitation expenditures (within the meaning of section 48(g) and this section) is section 38 property. Property that is section 38 property by reason of section 48(a)(1)(E) is treated as new section 38 property and, therefore, is not subject to the used property limitation in section 48(c). Section 48(g)(1) and paragraph (b) of this section define the term ''qualified rehabilitated building.'' Section 48(g)(2) and paragraph (c) of this section define the term ''qualified rehabilitation expenditure.'' Section 48(g) (2)(B)(iv) and (3) and paragraph (d) of this section describe the rules applicable to ''certified historic structures.'' Section 48(q) and paragraph (e) of this section provide rules concerning an adjustment to the basis of the rehabilitated building. Paragraph (f) of this section provides guidance for coordination of these provisions with other sections of the Code, including rules for determining when the rehabilitation credit may be claimed.

(2) *Effective dates and transition rules*—(i) *In general*. Except as otherwise provided in this paragraph (a)(2)(i), this section applies to expenditures incurred after December 31, 1981, in connection with the rehabilitation of a qualified rehabilitated building. (See paragraph (c)(3)(i) of this section for rules concerning the determination of when an expenditure is incurred.) If, however, physical work on the rehabilitation began before January 1, 1982, and the building does not meet the requirements of paragraph (b) of this section, the rules in § 1.48–11 shall apply to the expenditures incurred after December 31, 1981, in connection with such rehabilitation. (See paragraph (b)(6)(i) of this section for rules determining when physical work on a rehabilitation begins.) The last sentence of paragraph (c)(8)(i) of this section applies to qualified rehabilitation expenditures that are qualified property under section 168(k)(2) or qualified New York Liberty Zone property under section 1400L(b) acquired by a taxpayer after September 10, 2001, and to qualified rehabilitation expenditures that are 50 percent bonus depreciation property under section 168(k)(4) acquired by a taxpayer after May 5, 2003.

(ii) *Transition rules concerning ACRS lives*. (A) For property placed in service before March 16, 1984, and any property subject to the exception set forth in section 111(g)(2) of Pub. L. 98–369 (Deficit Reduction Act of 1984), the references to ''19 years'' in paragraph (c)(4)(ii) and (7)(v) shall be replaced with ''15 years'' and the reference to ''19-year real property'' in paragraph (c)(4)(ii) shall be replaced with ''15-year real property.''

(B) Except as otherwise provided in paragraph (a)(2)(ii)(A) of this section, for property placed in service before May 9, 1985, and any property subject to the exception set forth in section 105(b) (2) and (5) of Pub. L. 99–121 (99 Stat. 501, 511), the reference to ''19 years'' in paragraph (c)(4)(ii) and (7)(v) shall be replaced with ''18 years'' and the references to ''19-years real property'' in paragraph (c)(4)(ii) shall be replaced with ''18-year real property.''

(iii) *Transition rule concerning external wall definition*. Notwithstanding the definition of external wall contained in paragraph (b)(3)(ii) of this section, in any case in which the written plans and specifications for a rehabilitation were substantially completed on or before June 28, 1985, and the building being rehabilitated would fail to meet the requirement of paragraph (b)(1)(iii) of this section if the definition of external wall in paragraph (b)(3)(ii) of this section were used, the term ''external wall'' shall be defined as a wall, including its supporting elements, with one face exposed to the weather or earth, and a common wall shall not be treated as an external wall. See paragraph (b)(2)(v) of this section for the definition of written plans and specifications.

(iv) *Transition rules concerning amendments made by the Tax Reform Act of 1986*—(A) *In general*. Except as otherwise provided in section 251(d) of the Tax Reform Act of 1986 and this paragraph (a)(2)(iv), the amendments made by section 251 of the Tax Reform Act of 1986 shall apply to property placed in service after December 31, 1986, in taxable years ending after that date, regardless of when the rehabilitation expenditures attributable to such property were incurred. If property attributable to qualified rehabilitation expenditures is incurred with respect to a rehabilitation to a building placed in service in segments or phases and some segments are placed in service before January 1, 1987, and the remaining segments are placed in service after December 31, 1986, the amendments under the Tax Reform Act would not apply to the property placed in service before January 1, 1987, but would apply to the segments placed in service after December 31, 1986, unless one of the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section applies.

(B) *General transition rule*. The amendments made by sections 251 and 201 of the Tax Reform Act of 1986 shall not apply to property that qualifies under section 251(d) (2), (3), or (4) of the Tax Reform Act of 1986. Property qualifies for the general transition rule in section 251(d)(2) of the Act if such property is placed in service before January

1, 1994, and if such property is placed in service as part of—

(*1*) A rehabilitation that was completed pursuant to a written contract that was binding on March 1, 1986, or

(*2*) A rehabilitation incurred in connection with property (including any leasehold interest) acquired before March 2, 1986, or acquired on or after such date pursuant to a written contract that was binding on March 1, 1986, if—

(*i*) Parts 1 and 2 of the Historic Preservation Certificate Application were filed with the Department of the Interior (or its designee) before March 2, 1986, or

(*ii*) The lesser of $1,000,000 or 5 percent of the cost of the rehabilitation is incurred before March 2, 1986, or is required to be incurred pursuant to a written contract which was binding on March 1, 1986.

(C) *Specific rehabilitations.* See section 251(d) (3) and (4) of the Tax Reform Act of 1986 for additional rehabilitations that are exempted from the amendments made by sections 251 and 201 of the Tax Reform Act of 1986.

(b) *Definition of qualified rehabilitated building*—(1) *In general.* The term ''qualified rehabilitated building'' means any building and its structural components—

(i) That has been substantially rehabilitated (within the meaning of paragraph (b)(2) of this section) for the taxable year,

(ii) That was placed in service (within the meaning of §1.46–3(d)) as a building by any person before the beginning of the rehabilitation, and

(iii) That meets the applicable existing external wall retention test or the existing external wall and internal structural framework retention test in accordance with paragraph (b)(3) of this section.

The requirement in paragraph (b)(1)(iii) of this section does not apply to a certified historic structure. See paragraphs (b) (4) and (5) of this section for additional requirements related to the definition of a qualified rehabilitated building.

(2) *Substantially rehabilitated building*—(i) *Substantial rehabilitation test.* A building shall be treated as having been substantially rehabilitated for a taxable year only if the qualified rehabilitation expenditures (as defined in paragraph (c) of this section) incurred during any 24-month period selected by the taxpayer ending with or within the taxable year exceed the greater of—

(A) The adjusted basis of the building (and its structural components), or (B) $5,000.

(ii) *Date to determine adjusted basis of the building*—(A) *In general.* The adjusted basis of the building (and its structural components) shall be determined as of the beginning of the first day of the 24-month period selected by the taxpayer or the first day of the taxpayer's holding period of the building (within the meaning of section 1250(e)), whichever is later. For purposes of determining the holding period under section 1250(e), any reconstruction that is part of the rehabilitation shall be disregarded.

(B) *Special rules.* In the event that a building is not owned by the taxpayer, the adjusted basis of the building shall be determined as of the date that would have been used if the owner had been the taxpayer. The adjusted basis of a building that is being rehabilitated by a taxpayer other than the owner shall thus be determined as of the beginning of the first day of the 24-month period selected by the taxpayer or the first day of the owner's holding period, whichever is later. Therefore, if a building that is being rehabilitated by a lessee is sold subject to the lease prior to the date that the lessee has substantially rehabilitated the building, the lessee's adjusted basis is determined as of the beginning of the first day of the new lessor's holding period or the beginning of the first day of the 24-month period selected by the lessee (the taxpayer), whichever is later. If, therefore, the first day of the new lessor's holding period were later than the first day of the 24-month period selected by the lessee (the taxpayer), the lessee's adjusted basis for purposes of the substantial rehabilitation test would be the same as the adjusted basis of the new lessor as determined under paragraph (b)(2)(vii) of this section. If a building is sold after the date that a lessee has substantially rehabilitated the building with respect to the original lessor's adjusted basis, however, the lessee's basis may be determined as of the first day of the 24-month period selected by the lessee or the first day of the original lessor's holding period, whichever is later, and the transfer of the building will not affect the adjusted basis for purposes of the substantial rehabilitation test. The preceding sentence shall not apply, however, if the building is sold to the lessee or a related party within the meaning of section 267(b) or section 707(b)(1).

(iii) *Adjusted basis of the building*—(A) *In general.* The term ''adjusted basis of the building'' means the aggregate adjusted basis (within the meaning of section 1011(a)) in the building (and its structural components) of all the parties who have an interest in the building.

(B) *Special rules.* In the case of a building that is leased to one or more tenants in whole or inpart, the adjusted basis of the building is determined by adding the adjusted basis of the owner (lessor) in the building to the adjusted basis of the lessee (or lessees) in the leasehold and any leasehold improvements that are structural components of the building. Similarly, in the case of a building that is divided into condominium units, the adjusted basis of the building means the aggregate adjusted basis of all of the respective condominium owners (including the basis of any lessee in the leasehold and leasehold improvements) in the building (and its structural components). If the adjusted basis of a building would be determined in whole or in part by reference to the adjusted basis of a person or persons other than the taxpayer (e.g., a rehabilitation by a lessee) and the taxpayer is unable to obtain the required information, the taxpayer must establish by clear and convincing evidence that the adjusted basis of such person or persons in the building on the date specified in paragraph (b)(2)(ii) of this section is an amount that is less than the amount of qualified rehabilitation expenditures incurred by the taxpayer. If no such amount can be so established, the adjusted basis of the building will be deemed to be the fair market value of the building on the relevant date. For purposes of determining the adjusted basis of a building, the portion of the adjusted basis of a building that is allocable to an addition (within the meaning of paragraph (b)(4)(ii) of this section) to the building that does not meet the age requirement in paragraph (b)(4)(i) of this section shall be disregarded. (See paragraph (b)(2)(vii) of this section for the rule applicable to the determination of the adjusted basis of a building when qualified rehabilitation expenditures are treated as incurred by the taxpayer.)

(iv) *Rehabilitation.* Rehabilitation includes renovation, restoration, or reconstruction of a building, but does not include an enlargement (within the meaning of paragraph (c)(10) of this section) of new construction. The determination of whether expenditures are attributable to the rehabilitation of an existing building or to new construction shall be based upon all the facts and circumstances.

(v) *Special rule for phased rehabilitation.* In the case of any rehabilitation that may reasonably be expected to be completed in phases set forth in written architectural plans and specifications completed before the physical work on the rehabilitation begins, paragraphs (b)(2) (i), (ii), and (vii) of this section shall be applied by substituting ''60-month period'' for ''24-month period.'' A rehabilitation may reasonably be expected to be completed in phases if it consists of two or more distinct stages of development. The determination of whether a rehabilitation consists of distinct stages and therefore may reasonably be expected to be completed in phases shall be made on the basis of all the relevant facts and circumstances in existence before physical work on the rehabilitation begins. For purposes of this paragraph and paragraph (a)(2)(iii) of this section, written plans that describe generally all phases of the rehabilitation process shall be treated as written architectural plans and specifications. Such written plans are not required to contain detailed working drawings or detailed specifications of the materials to be used. In addition, the taxpayer may include a description of work to be done by lessees in the written plans. For example, where the owner of a vacant four story building plans to rehabilitate two floors of the building and plans to require, as a condition of any lease, that tenants of the other two floors must rehabilitate those floors, the requirements of this paragrpah (b)(2)(v) shall be met if the owner provides written plans for the rehabilitation work to be done by the owner and a description of the rehabilitation work that the tenants will be required to complete. The work required of the tenants may be described in the written plans in terms of minimum specifications (e.g., as to lighting, wiring, materials, appearance) that must be met by such tenants. See paragraph (b)(6)(i) of this section for the definition of physical work on a rehabilitation.

(vi) *Treatment of expenses incurred by persons who have an interest in the building*. For purposes of the substantial rehabilitation test in paragraph (b)(2)(i) of this section, the taxpayer may take into account qualified rehabilitation expenditures incurred during the same rehabilitation process by any other person who has an interest in the building. Thus, for example, to determine whether a building has been substantially rehabilitated, a lessee may include the expenditures of the lessor and of other lessees; a condominium owner may include the expenditures incurred by other condominium owners; and an owner may include the expenditures of the lessees.

(vii) *Special rules when qualified rehabilitation expenditures are treated as incurred by the taxpayer*. In the case where qualified rehabilitation expenditures are treated as having been incurred by a taxpayer under paragraph (c)(3)(ii) of this section, the transferee shall be treated as having incurred the expenditures incurred by the transferor on the date that the transferor incurred the expenditures within the meaning of paragraph (c)(3)(i) of this section. For purposes of the substantial rehabilitation test in paragrpah (b)(2)(i) of this section, the transferee's adjusted basis in the building shall be determined as of the beginning of the first day of a 24-month period, or the first day of the transferee's holding period, whichever is later, as provided in paragraph (b)(2)(ii) of this section. The transferee's basis as of the first day of the transferee's holding period for purposes of the substantial rehabilitation test in paragraph (b)(2)(i) of this section, however, shall be considered to be equal to the transferee's basis in the building on such date less—

(A) The amount of any qualified rehabilitation expenditures incurred (or treated as having been incurred) by the transferor during the 24-month period that are treated as having been incurred by the transferee under paragraph (c)(3)(ii) of this section, and

(B) The amount of qualified rehabilitation expenditures incurred before the transfer and during the 24-month period by any other person who has an interest in the building (e.g., a lessee of the transferor). The preceding sentence shall not apply, however, unless the transferee's basis in the building is determined with reference to (*1*) the transferee's cost of the building (including the rehabilitation expenditures), (*2*) the transferor's basis in the building (where such basis includes the amount of the expenditures), or (*3*) any other amount that includes the cost of the rehabilitation expenditures. In the event that the transferee's basis is determined with reference to an amount not described above (e.g., transferee's basis in one building is determined with reference to the transferee's basis in another building under section 1031(d)), the amount of the expenditures incurred by the transferor and treated as having been incurred by the transferee are not deducted from the transferee's basis for purposes of the substantial rehabilitation test. If a transferee's basis is determined under section 1014 or section 1022, any expenditures incurred by the decedent within the measuring period that are treated as having been incurred by the transferee under paragraph (c)(3)(ii) of this section shall decrease the transferee's basis for purposes of the substantial rehabilitation test.

(viii) *Statement of adjusted basis, measuring period, and qualified rehabilitation expenditures*. In the case of any tax return filed after August 27, 1985, on which an investment tax credit for property, described in section 48(a)(1)(E) is claimed, the taxpayer shall indicate by way of a marginal notation on, or a supplemental statement attached to, Form 3468—

(A) The beginning and ending dates for the measuring period selected by the taxpayer under section 48(g)(1)(C)(i) and paragraph (b)(2) of this section,

(B) The adjusted basis of the building (within the meaning of paragraph (b)(2)(iii) or (vii) of this section) as of the beginning of such measuring period, and

(C) The amount of qualified rehabilitation expenditures incurred, and treated as incurred, respectively, during such measuring period.

Furthermore, for returns filed after August 27, 1985, if the adjusted basis of the building for purposes of the substantial rehabilitation test is determined in whole or in part by reference to the adjusted basis of a person, or persons, other than the taxpayer (e.g., a rehabilitation by a lessee), the taxpayer must attach to the Form 3468 filed with the tax return on which the credit is claimed a statement addressed to the District Director, signed by such third party, that states the first day of the third party's holding period and the amount of the adjusted basis of such third party in the building at the beginning of the measuring period or the first day of the holding period, whichever is later. If the taxpayer is unable to obtain the required information, that fact should be indicated and the taxpayer should state the manner in which the adjusted basis was determined and, if different, the fair market value of the building on the relevant date.

(ix) *Partnerships and S corporations.* If a building is owned by a partnership (*i.e.*, the building is partnership property) or an S corporation, the substantial rehabilitation test shall be determined at the entity level. Thus, the entity shall compare the amount of qualified rehabilitation expenditures incurred during the measuring period against its basis in the building at the beginning of its holding period or the beginning of its measuring period, whichever is later. (See section 1223(2) for rules concerning the determination of a partnership's holding period in the case of a contribution of property to the partnership meeting the requirements of section 721.) The adjusted basis of the building to a partnership shall be determined by taking into account any adjustments to the basis of the building made under section 743 and section 734. Any adjustments to the building's basis that are made under section 743 or section 734 after the beginning of the partnership's holding period, but before the end of the measuring period, shall be deemed for purposes of the substantial rehabilitation test to have been made on the first day of the partnership's holding period. However, in such case, the partnership's basis in the building shall be reduced by the amount of qualified rehabilitation expenditures incurred by the partnership. In the case of any tax return filed after January 9, 1989 on which a credit is claimed by a partner or a shareholder of an S corporation for rehabilitation expenditures incurred by a partnership or an S corporation, the partner or shareholder shall indicate on the Form 3468 on which the credit is claimed the name, address, and identification number of the partnership or S corporation that incurred the rehabilitation expenditures, and the partnership or S corporation shall, by way of a marginal notation on or a supplemental statement attached to the entity's return, provide the information required by paragraph (b)(2)(viii) of this section.

(x) *Examples.* The following examples illustrate the application of the substantial rehabilitation test in this paragraph (b)(2):

Example 1. Assume that A, a calendar year taxpayer, purchases a building for $140,000 on January 1, 1982, incurs qualified rehabilitation expenditures in the amount of $48,000 (at the rate of $4,000 per month) in 1982, $100,000 in 1983, and $20,000 (at the rate of $2,000 per month) in the first ten months of 1984, and places the rehabilitated building in service on October 31, 1984. Assume that A did not have written architectural plans and specifications describing a phased rehabilitation within the meaning of paragraph (b)(2)(v) of this section in existence prior to the beginning of physical work on the rehabilitation. For purposes of the substantial rehabilitation test in paragraph (b)(2) of this section, A may select any 24-consecutive-month measuring period that ends in 1984, the taxable year in which the rehabilitated building was placed in service. Assume that on A's 1984 return, A selects a measuring period beginning on February 1, 1982, and ending on January 31, 1984, and specifies that A's basis in the building (within the meaning of section 1011(a)) was $144,000 on February 1, 1982

($140,000 + $4,000). (The $4,000 of rehabilitation expenditures incurred during January 1982 are included in A's basis under section 1011 even though such property has not been placed in service.) The amount of qualified rehabilitation expenditures incurred during the measuring period was $146,000 ($44,000 from February 1 to December 31, 1982, plus $100,000 in 1983, plus $2,000 in January 1984). The building shall be treated as ''substantially rehabilitated'' within the meaning of this paragraph (b)(2) for A's 1984 taxable year because the $146,000 of expenditures incurred by A during the measuring period exceeded A's adjusted basis of $144,000 at the beginning of the period. If the other requirements of section 48(g)(1) and this paragraph are met, the building is treated as a qualified rehabilitated building, and A can treat as qualified rehabilitation expenditures the amount of $168,000 (*i.e.*, $146,000 of expenditures incurred during the measuring period, $4,000 of expenditures incurred prior to the beginning of the measuring period as part of the rehabilitation process, and $18,000 of expenditures incurred after the measuring period during the taxable year within which the measuring period ends (See paragraph (c)(6) of this section.)). The result would generally be the same if the property attributable to the rehabilitation expenditures was placed in service as the expenditures were incurred, but A would have $148,000 of qualified rehabilitation expenditures for 1983 and $20,000 of qualified rehabilitation expenditures for 1984. (See paragraph (f)(2) of this section).

Example 2. Assume the same facts as in example 1, except that additional rehabilitation expenditures are incurred after the portion of the basis of the building attributable to qualified rehabilitation expenditures was placed in service on October 31, 1984. Such expenditures are incurred through the end of 1984 and in 1985 when the portion of the basis attributable to the additional expenditures is placed in service. The fact that the building qualified as a substantially rehabilitated building for A's 1984 taxable year has no effect on whether the building is a qualified rehabilitated building for property placed in service in A's 1985 taxable year. In order to determine whether the building is a qualified rehabilitated building for A's 1985 taxable year, A must select a measuring period that ends in 1985 and compare the expenditures incurred within that period with the adjusted basis as of the beginning of the period. Solely for the purpose of determining whether the building was substantially rehabilitated for A's 1985 taxable year, expenditures incurred during 1983 and 1984, even though considered in determining whether the building was substantially rehabilitated in 1984, may also be used to determine whether the building was substantially rehabilitated for A's 1985 taxable year, provided the expenditures were incurred during any 24-month measuring period selected by A that ends in 1985.

Example 3. (i) Assume the B purchases a building for $100,000 on January 1, 1982, and leases the building to C who rehabilitates the building. Assume that C, a calendar year taxpayer, places the property with respect to which rehabilitation expenditures were made in service in 1982 and selects December 31, 1982, as the end of the measuring period for purposes of the substantial rehabilitation test. The beginning of the measuring period is January 2, 1982, the beginning of B's holding period under section 1250(e), and the adjusted basis of the building is $100,000. Accordingly, if C incurred more than $100,000 of qualified rehabilitation expenditures during 1982, the building would be substantially rehabilitated within the meaning of paragraph (b)(2)(i) of this section.

(ii) Assume the facts of example 3(i), except that after C begins physical work on the rehabilitation, but before C incurs $100,000 of expenditures, D acquires the building, subject to C's lease, from B for $200,000. D's holding period under section 1250(e) begins on the day after D acquired the building, and C's adjusted basis for purposes of the substantial rehabilitation test is $200,000, less the amount of expenditures incurred by C before the transfer. (See paragraphs (b)(2) (ii) and (vii) of this section.) Accordingly, if C incurred more than $200,000 (less the amount of expenditures incurred prior to the transfer) of qualified rehabilitation expenditures during 1982, the building would be substantially rehabilitated within the meaning of paragraph (b)(2) of this section. Under paragraph (b)(2)(ii)(B) of this section, however, C's adjusted basis for purposes of the substantial rehabilitation test would be $100,000 if C had substantially rehabilitated the building (*i.e.*, incurred more than $100,000 in rehabilitation expenditures) prior to B's sale to D.

Example 4. E owns a building with a basis of $10,000 and E incurs $5,000 of rehabilitation expenditures. Before completing the rehabilitation project, E sells the building to F for $30,000. Assume that F is treated under paragraph (c)(3)(ii) of this section as having incurred the $5,000 of rehabilitation expenditures actually incurred by E. Because F's basis in the building is determined under section 1011 with reference to F's $30,000 cost of the building (which includes the property attributable to E's rehabilitation expenditures), F's basis for purposes of the substantial rehabilitation test is $25,000 ($30,000 cost basis less $5,000 rehabilitation expenditures treated as if incurred by F). (See paragraph (b)(2)(vii) of this section.) F would thus be required to incur more than $20,000 of rehabilitation expenditures (in addition to the $5,000 incurred by E and treated as having been incurred by F) during a measuring period selected by F to satisfy the substantial rehabilitation test.

Example 5. G owns Building I with a basis of $10,000 and a fair market value of $20,000. H owns Building II with a basis of $5,000 and a fair market value of $20,000, with respect to which H has incurred $1,000 of rehabilitation expenditures. G and H exchange their buildings in a transaction that qualifies for nonrecognition treatment under section 1031. Assume that G is treated under paragraph (c)(3)(ii) of this section as having incurred $1,000 of rehabilitation expenditures. G's basis in Building II, computed under section 1031(d), is $10,000. G's basis in Building II is not determined with reference to (A) the cost of Building II, (B) H's basis in Building II (including the cost of the rehabilitation expenditures) or (C) any other amount that includes the cost of expenditures, but is instead determined with reference to G's basis in other property (Building I). Therefore, G's basis in Building II for purposes of the substantial rehabilitation test is not reduced by the $1,000 of rehabilitation expenditures treated as if incurred by G. (See paragraph (b)(2)(vii) of this section.) Accordingly, G's basis in Building II for purposes of the substantial rehabilitation test is $10,000, and G must incur additional rehabilitation expenditures in excess of $9,000 within a measuring period selected by G to satisfy the test.

(3) *Retention of existing external walls and internal structural framework*—(i) *In general*—(A) *Property placed in service after December 31, 1986.* Except in the case of property that qualifies for the transition rules in paragraphs (a)(2)(iv) (B) and (C) of this section, in the case of property that is placed in service after December 31, 1986, a building (other than a certified historic structure) meets the requirement in paragraph (b)(1)(iii) of this section only if in the rehabilitation process—

(*1*) 50 percent or more of the existing external walls of such building are retained in place as external walls;

(*2*) 75 percent or more of the existing external walls of such building are retained in place as internal or external walls; and

(*3*) 75 percent or more of the internal structural framework of such building (as defined in paragraph (b)(3)(iii) of this section) is retained in place.

(B) *Expenditures incurred before January 1, 1984, for property placed in service before January 1, 1987.* With respect to rehabilitation expenditures incurred before January 1, 1984, for property that is either placed in service before January 1, 1987, or that qualifies for the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, a building meets the requirement in paragraph (b)(1)(iii) of this section only if 75 percent or more of the existing external walls of the building are retained in place as external walls in the rehabilitation process. If an addition to a building is not treated as part of a qualified rehabilitated building because it does not meet the 30-year requirement in paragraph (b)(4)(i)(B) of this section, then the external walls of such addition shall not be considered to be existing external walls of the building for purposes of section 48(g)(1)(A)(iii) (as in effect prior to enactment of the Tax Reform Act of 1986), and this section.

(C) *Expenditures incurred after December 31, 1983, for property placed in service before January 1, 1987.* With respect to expenditures incurred after December 31, 1983, for property that is either placed in service before January 1, 1987, or that qualifies for the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, the requirement of paragraph (b)(1)(iii) of this section is satisfied only if in the rehabilitation process either the existing external wall retention requirement in paragraph (b)(3)(i) (B) of this section is satisfied, or:

(*1*) 50 percent or more of the existing external walls of the building are retained in place as external walls,

(*2*) 75 percent or more of the existing external walls are retained in place as internal or external walls, and

(*3*) 75 percent or more of the existing internal structural framework of such building is retained in place.

(D) *Area of external walls and internal structural framework.* The determinations required by paragraphs (b)(3)(i) (A), (B), and (C) of this section shall be based upon the area of the external walls or internal structural framework that is retained in place compared to the total area of each prior to the rehabilitation. The area of the existing external walls and internal structural framework of a building shall be determined prior to any destruction, modification, or construction of external walls or internal structural framework that is undertaken by any party in anticipation of the rehabilitation.

(ii) *Definition of external wall.* For purposes of this paragraph (b), a wall includes both the supporting elements of the wall and the nonsupporting elements, (e.g., a curtain, windows or doors) of the wall. Except as otherwise provided in this paragraph (b)(3), the term ''external wall'' includes any wall that has one face exposed to the weather, earth, or an abutting wall of an adjacent building. The term ''external wall'' also includes a shared wall (*i.e.*, a single wall shared with an adjacent building), generally referred to as a ''party wall,'' provided that the shared wall has no windows or doors in any portion of the wall that does not have one face exposed to the weather, earth, or an abutting wall. In general, the term ''external wall'' includes only those external walls that form part of the outline or perimeter of the building or that surround an uncovered courtyard. Therefore, the walls of an uncovered internal shaft, designed solely to bring light or air into the center of a building, which are completely surrounded by external walls of the building and which enclose space not designated for occupancy or other use by people (other than for maintenance or emergency), are not considered external walls. Thus, for example, a wall of a light well in the center of a building is not an external wall. However, walls surrounding an outdoor space which is usable by people, such as a courtyard, are external walls.

(iii) *Definition of internal structural framework.* For purposes of this section, the term ''internal structural framework'' includes all load-bearing internal walls and any other internal structural supports, including the columns, girders, beams, trusses, spandrels, and all other members that are essential to the stability of the building.

(iv) *Retained in place.* An existing external wall is retained in place if the supporting elements of the wall are retained in place. An existing external wall is not retained in place if the supporting elements of the wall are replaced by new supporting elements. An external wall is retained in place, however, if the supporting elements are reinforced in the rehabilitation, provided that such supporting elements of the external wall are retained in place. An external wall also is retained in place if it is covered (e.g., with new siding). Moreover, an external wall is retained in place if the existing curtain is replaced with a new curtain, provided that the structural framework that provides for the support of the existing curtain is retained in place. An external wall is retained in place notwithstanding that the existing doors and windows in the wall are modified, eliminated, or replaced. An external wall is retained in place if the wall is disassembled and reassembled, provided the same supporting elements are used when the wall is reassembled and the configuration of the external walls of the building after the rehabilitation is the same as it was before the rehabilitation process commenced. Thus, for example, a brick wall is considered retained in place even though the original bricks are removed (for cleaning, etc.) and replaced to form the wall. The principles of this paragraph (b)(3)(iv) shall also apply to determine whether internal structural framework of the building is retained in place.

(v) *Effect of additions.* If an existing external wall is converted into an internal wall (*i.e.*, a wall that is not an external wall), the wall is not retained in place as an external wall for purposes of this section.

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

Example 1. Taxpayer A rehabilitated a building all of the walls of which consisted of wood siding attached to gypsum board sheets (which covered the supporting elements of the wall, *i.e.*, studs). A covered the existing wood siding with aluminum siding as part of a rehabilitation that otherwise qualified under this subparagraph. The addition of the aluminum siding does not affect the status of the existing external walls as external walls and they would be considered to have been retained in place.

Example 2. Taxpayer B rehabilitated a building, the external walls of which had a masonry curtain. The masonry on the wall face was replaced with a glass curtain. The steel beam and girders supporting the existing masonry curtain were retained in place. The walls of the building are considered to be retained in place as external walls, notwithstanding the replacement of the curtain.

Example 3. Taxpayer C rehabilitated a building that has two external walls measuring 75′ × 20′ and two other external walls measuring 100′ × 20′. C demolished one of the larger walls, including its supporting elements and constructed a new wall. Because one of the larger walls represents more than 25 percent of the area of the building's external walls, C has not satisfied the requirements that 75 percent of the existing external walls must be retained in place as either internal or external walls. If however, C had not demolished the wall, but had converted it into an internal wall (e.g., by building a new external wall), the building would satisfy the external wall requirements.

Example 4. The facts are the same as in example 3, except that C does not tear down any walls, but builds an addition that results in one of the smaller walls becoming an internal wall. In addition, C enlarged 8 of the existing windows on one of the larger walls, increasing them from a size of 3′ × 4′ to 6′ × 8′. Since the smaller wall accounts for less than 25 percent of the total wall area, C has satisfied the requirement that 75 percent of the existing external walls must be retained in place as external walls in the rehabilitation process. The enlargement of the existing windows on the larger wall does not affect its status as an external wall.

Example 5. Taxpayer D rehabilitated a building that was in the center of a row of three buildings. The building being rehabilitated by D shares its side walls with the buildings on either side. The shared walls measure 100′ × 20′ and the rear and front walls measure 75′ × 20′. As part of a rehabilitation, D tears down and replaces the front wall. Because the shared walls as well as the front and back walls are considered external walls and the front wall accounts for less than 25 percent of the total external wall area (including the shared walls), D has satisfied the requirement that 75 percent of the existing external walls must be retained in place as external walls in the rehabilitation process.

(4) *Age requirement*—(i) *In general*—(A) *Property placed in service after December 31, 1986*. Except in the case of property that qualifies for the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, a building other than a certified historic structure shall not be considered a qualified rehabilitated building unless the building was first placed in service (within the meaning of §1.46–3(d)) before January 1, 1936.

(B) *Property placed in service before January 1, 1987, and property qualifying under a transition rule.* In the case of property placed in service before January 1, 1987, and property that qualifies under the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, a building other than a certified historic structure is considered a qualified rehabilitated building only if a period of at least 30 years has elasped between the date physical work on the rehabilitation of the building began and the date the building was first placed in service (within the meaning of §1.46–3(d)) as a building by any person.

(ii) *Additions.* A building that was first placed in service before 1936 in the case described in paragraph (b)(4)(i)(A) of this section, or at least 30 years before physical work on the rehabilitation began in the case described in paragraph (b)(4)(i)(B) of this section, will not be disqualified because additions to such building have been added since 1936 in the case described in paragraph (b)(4)(i)(A) of this section, or are less than 30 years old in the case described in paragraph (b)(4)(i)(B) of this section. Such additions, however, shall not be treated as part of the qualified rehabilitated building. The term ''addition'' means any construction that resulted in any portion of an external wall becoming an internal wall, that resulted in an increase in the height of the building, or that increased the volume of the building.

(iii) *Vacant periods.* The determinations required by paragraph (b)(4)(i) of this section include periods during which a building was vacant or devoted to a personal use and is computed without regard to the number of owners or the identify of owners during the period.

(5) *Location at which the rehabilitation occurs.* A building, other than a certified historic structure is not a qualified rehabilitated building unless it has been located where it is rehabilitated since before 1936 in the case described in paragraph (b)(4)(i)(A) of this section. Similarly, in the case described in paragraph (b)(4)(i)(B) of this section, a building, other than a certified historic structure, is not a qualified rehabilitation building unless it has been located where it is rehabilitated for the thirty-year period immediately preceding the date physical work on the rehabilitation began in the case of a ''30-year building'' or the forty-year period immediately preceding the date physical work on the rehabilitation began in the case of a ''40-year building.'' (See §1.46–1(q)(1)(iii) for the definitions of

''30-year building'' and ''40-year building.'')

(6) *Definition and special rule*—(i) *Physical work on a rehabilitation.* For purposes of this section, ''physical work on a rehabilitation'' begins when actual construction, or destruction in preparation for construction, begins. The term ''physical work on a rehabilitation,'' however, does not include preliminary activities such as planning, designing, securing financing, exploring, researching, developing plans and specifications, or stabilizing a building to prevent deterioration (e.g., placing boards over broken windows).

(ii) *Special rule for adjoining buildings that are combined.* For purposes of this paragraph (b), if as part of a rehabilitation process two or more adjoining buildings are combined and placed in service as a single building after the rehabilitation process, then, at the election of the taxpayer, all of the requirements for a qualified rehabilitated building in section 48(g)(1) and this section may be applied to the constituent adjoining buildings in the aggregate. For example, if such requirements are applied in the aggregate, any shared walls or abutting walls between the constituent buildings that would otherwise be treated as external walls (within the meaning of paragraph (b)(3) of this section) would not be treated as external walls of the building, and the substantial rehabilitation test in paragraph (b)(2) of this section would be applied to the aggregate expenditures with respect to all of the constituent buildings and to the aggregate adjusted basis of all of the constituent buildings. A taxpayer shall elect the special rule of this paragraph (b)(6)(ii) for adjoining buildings by indicating by way of a marginal notation on, or a supplemental statement attached to, the Form 3468 on which a credit is first claimed for qualified rehabilitation expenditures with respect to such buildings that such buildings are a single qualified rehabilitated building because of the application of the special rule in this paragraph (b)(6)(ii).

(c) *Definition of qualified rehabilitation expenditures*—(1) *In general.* Except as otherwise provided in paragraph (c)(7) of this section, the term ''qualified rehabilitation expenditure'' means any amount that is—

(i) Properly chargeable to capital account (as described in paragraph (c)(2) of this section),

(ii) Incurred by the taxpayer after December 31, 1981 (as described in paragraph (c)(3) of this section),

(iii) For property for which depreciation is allowable under section 168 and which is real property described in paragraph (c)(4) of this section, and

(iv) Made in connection with the rehabilitation of a qualified rehabilitated building (as described in paragraph (c)(5) of this section).

(2) *Chargeable to capital account.* For purposes of paragraph (c)(1) of this section, amounts are chargeable to capital account if they are properly includible in computing basis of real property under §1.46–3(c). Amounts treated as an expense and deducted in the year they are paid or incurred or amounts that are otherwise not added to the basis of real property described in paragraph (c)(4) of this section do not qualify. For purposes of this paragraph (c), amounts incurred for architectural and engineering fees, site survey fees, legal expenses, insurance premiums, development fees, and other construction related costs, satisfy the requirement of this paragraph (c)(2) if they are added to the basis of real property that is described in paragraph (c)(4) of this section. Construction period interest and taxes that are amortized under section 189 (as in effect prior to its repeal by the Tax Reform Act of 1986) do not satisfy the requirement of this paragraph (c)(2). If, however, such interest and taxes are treated by the taxpayer as chargeable to capital account with respect to property described in paragraph (c)(4) of this section, they shall be treated in the same manner as other costs described in this paragraph (c)(2). Any construction period interest or taxes or other fees or costs incurred in connection with the acquisition of a building, any interest in a building, or land, are subject to paragraph (c)(7)(ii) of this section. See paragraph (c)(9) of this section for additional rules concerning interest.

(3) *Incurred by the taxpayer*—(i) *In general*. Qualified rehabilitation expenditures are incurred by the taxpayer for purposes of this section on the date such expenditures would be considered incurred under an accrual method of accounting, regardless of the method of accounting used by the taxpayer with respect to other items of income and expense. If qualified rehabilitation expenditures are treated as having been incurred by a taxpayer under paragraph (c)(3)(ii) of this section, the taxpayer shall be treated as having incurred the expenditures on the date such expenditures were incurred by the transferor.

(ii) *Qualified rehabilitation expenditures treated as incurred by the taxpayer*—(A) Where rehabilitation expenditures are incurred with respect to a building by a person (or persons) other than the taxpayer and the taxpayer subsequently acquires the building, or a portion of the building to which some or all of the expenditures are allocable (e.g., a condominium unit to which rehabilitation expenditures have been allocated), the taxpayer acquiring such property shall be treated as having incurred the rehabilitation expenditures actually incurred by the transferor (or treated as incurred by the transferor under this paragraph (c)(3)(ii)) allocable to the acquired property, provided that—

(*1*) The building, or the portion of the building, acquired by the taxpayer was not used (or, if later, was not placed in service (as defined in paragraph (f)(2) of this section)) after the rehabilitation expenditures were incurred and prior to the date of acquisition, and

(*2*) No credit with respect to such qualified rehabilitation expenditures is claimed by anyone other than the taxpayer acquiring the property. For purposes of this paragraph (c)(3)(ii), use shall mean actual use, whether personal or business. In the case of a building that is divided into condominium units, expenditures attributable to the common elements shall be allocable to the individual condominium units in accordance with the principles of paragraph (c)(10)(ii) of this section. Furthermore, for purpose of this paragraph (c)(3)(ii), a condominium unit's share of the common elements shall not be considered to have been used (or placed in service) prior to the time that the particular condominium unit is used.

(B) The amount of rehabilitation expenditures described in paragraph (c)(3)(ii)(A) of this section treated as incurred by the taxpayer under this paragraph shall be the lesser of—

(*1*) The amount of rehabilitation expenditures incurred before the date on which the taxpayer acquired the building (or portion thereof) to which the rehabilitation expenditures are attributable, or

(*2*) The portion of the taxpayer's cost or other basis for the property that is properly allocable to the property resulting from the rehabilitation expenditures described in paragraph (c)(3)(ii)(B)(*1*) of this section.

(C) For purposes of this paragraph (c)(3)(ii), the amount of rehabilitation expenditures treated as incurred by the taxpayer under this paragraph (c) shall not be treated as costs for the acquisition of a building. The portion of the cost of acquiring a building (or an interest therein) that is not treated under this paragraph as qualified rehabilitation expenditures incurred by the taxpayer is not treated as section 38 property in the hands of the acquiring taxpayer. (See paragraph (c)(7)(ii) of this section.) (See paragraph (b)(2)(vii) for rules concerning the application of the substantial rehabilitation test when expenditures are treated as incurred by the taxpayer.)

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

Example 1. In 1981, A, a taxpayer using the cash receipts and disbursements method of accounting, commenced the rehabilitation of a 30-year old building. In June 1981, A signed a contract with a plumbing contractor for replacement of the plumbing in the building. A agreed to pay the contractor as soon as the work was completed. The work was completed in December 1981, but A did not pay the amount due until January 15, 1982. The expenditures for the plumbing are not qualified rehabilitation expenditures (within the meaning of this paragraph (c)) because they were not incurred under an accrual method of accounting after December 31, 1981.

Example 2. B incurred qualified rehabilitation expenditures of $300,000 with respect to an existing building between January 1, 1982, and May 15, 1982, and then sold the building to C on June 1, 1982. The portion of the building to which the expenditures were allocable was not used by B or any other person during the period from January 1, 1982, to June 1, 1982, and neither B nor any other person claimed the credit. Consequently, C will be treated as having incurred the expenditures on the dates that B incurred the expenditures.

Example 3. D, a taxpayer using the cash receipts and disbursements method of accounting, begins the rehabilitation of a building on January 11, 1982. Prior to May 1, 1982, D makes rehabilitation expenditures of $16,000. On May 3, 1982, D sells the building, the land, and the property attributable to the rehabilitation expenditures to E for $35,000. The purchase price is properly allocable as follows:

Land	$5,000
Existing building	11,000
Property attributable to rehabilitation expenditures	19,000
Total purchase price	35,000

The property attributable to the rehabilitation expenditures is placed in service by E on September 5, 1982. E may treat a portion of the $35,000 purchase price as rehabilitation expenditures paid or incurred by him. Since the rehabilitation expenditures paid by D ($16,000) are less than the portion of the purchase price properly allocable to property attributable to these expenditures ($19,000), E may treat only $16,000 as rehabilitation expenditures paid or incurred by him. The excess of the purchase price allocable to rehabilitation expenditures ($19,000) over the rehabilitation expenditures paid by D ($16,000), or $3,000, is treated as the cost of acquiring an interest in the building and is not a qualified rehabilitation expenditure treated as incurred by E.

Example 4. The facts are the same as in example 3, except that the purchase price properly allocable to the property attributable to rehabilitation expenditures is $15,000. Under these circumstances, E may treat only $15,000 of D's $16,000 expenditures as rehabilitation expenditures paid by D. The excess of the rehabilitation expenditures paid by D ($16,000) over the purchase price allocable to rehabilitation expenditures ($15,000), or $1,000, is treated as the cost of acquiring an interest in the building and is not a qualified rehabilitation expenditure treated as incurred by E.

(4) *Incurred for depreciable real property*—(i) *Property placed in service after December 31, 1986.* Except as otherwise provided in paragraph (c)(4)(ii) of this section (relating to certain property that qualifies under a transition rule), in the case of property placed in service after December 31, 1986, an expenditure is incurred for depreciable real property for purposes of paragraph (c)(1)(iii) of this section, only if it is added to the depreciable basis of depreciable property which is—

(A) Nonresidential real property,

(B) Residential rental property,

(C) Real property which has a class life of more than 12.5 years, or

(D) An addition or improvement to property described in paragraph (c)(4)(i) (A), (B), or (C) of this section.

For purposes of this paragraph (c)(4)(i), the terms ''nonresidential real property'', ''residential rental property'', and ''class life'' have the respective meanings given to such terms by section 168 and the regulations thereunder.

(ii) *Property placed in service before January 1, 1987, and property that qualifies under a transition rule.* In the case of property placed in service before January 1, 1987, and property placed in service after December 31, 1986, that qualifies for the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, an expenditure attributable to such property shall be a qualified rehabilitation expenditure only if such expenditure is incurred for property that is real property (or additions or improvements to real property) with a recovery period (within the meaning of section 168 as in effect prior to its amendment by the Tax Reform Act of 1986) of 19 years (15 years for low-income housing) and if the other requirements of this paragraph (c) are met. For purposes of this section, an expenditure is incurred for recovery property having a recovery period of 19 years only if the amount of the expenditure is added to the basis of property which is 19-year real property or 15-year real property in the case of low-income housing. For purposes of this section, the term ''low-income housing'' has the meaning given such term by section 168(c)(2)(F) (as in effect prior to the amendments made by the Tax Reform Act of 1986).

(5) *Made in connection with the rehabilitation of a qualified rehabilitated building.* In order for an expenditure to be a qualified rehabilitation expenditure, such expenditure must be incurred in connection with a rehabilitation (as defined in paragraph (b)(2)(iv)

of this section) of a qualified rehabilitated building. Expenditures attributable to work done to facilities related to a building (e.g., sidewalk, parking lot, landscaping) are not considered made in connection with the rehabilitation of a qualified rehabilitated building.

(6) *When expenditures may be incurred.* An expenditure is a qualified rehabilitation expenditure only if the building with respect to which the expenditures are incurred is substantially rehabilitated (within the meaning of paragraph (b)(2) of this section) for the taxable year in which the property attributable to the expenditures is placed in service (*i.e.*, the building is substantially rehabilitated during a measuring period ending with or within the taxable year in which a credit is claimed). (See paragraph (f)(2) of this section for rules relating to when property is placed in service.) Once the substantial rehabilitation test is met for a taxable year, the amount of qualified rehabilitation expenditures upon which a credit can be claimed for the taxable year is limited to expenditures incurred:

(i) Before the beginning of a measuring period during which the building was substantially rehabilitated that ends with or within the taxable year, provided that the expenditures were incurred in connection with the rehabilitation process that resulted in the substantial rehabilitation of the building;

(ii) Within a measuring period during which the building was substantially rehabilitated that ends with or within the taxable year, and

(iii) After the end of a measuring period during which the building was substantially rehabilitated but prior to the end of the taxable year with or within which the measuring period ends.

(7) *Certain expenditures excluded from qualified rehabilitation expenditures.* The term ''qualified rehabilitation expenditures'' does not include the following expenditures:

(i) Except as otherwise provided in paragraph (c)(8) of this section, any expenditure with respect to which the taxpayer does not use the straight line method over a recovery period determined under section 168 (c) and (g).

(ii) The cost of acquiring a building, any interest in a building (including a leasehold interest), or land, except as provided in paragraph (c)(3)(ii) of this section.

(iii) Any expenditure attributable to an enlargement of a building (within the meaning of paragraph (c)(10) of this section).

(iv) Any expenditure attributable to the rehabilitation of a certified historic structure or a building located in a registered historic district, unless the rehabilitation is a certified rehabilitation. (See paragraph (d) of this section which contains definitions and special rules applicable to rehabilitations of certified historic structures and buildings located in registered historic districts.)

(v) Any expenditure of a lessee of a building or a portion of a building, if, on the date the rehabilitation is completed with respect to property placed in service by such lessee, the remaining term of the lease (determined without regard to any renewal period) is less than the recovery period determined under section 168(c) (or 19 years in the case of property placed in service before January 1, 1987, and property placed in service that qualifies under the transition rules in paragraph (a)(2)(iv)(B) or (C) of this section).

(vi) Any expenditure allocable to that portion of a building which is (or may reasonably be expected to be) tax-exempt use property (within the meaning of section 168 and the regulations thereunder), except that the exclusion in this paragraph (c)(7)(vi) shall not apply for purposes of determining whether the building is a substantially rehabilitated building under paragraph (b)(2) of this section.

(8) *Requirement to use straight line depreciation*—(i) *Property placed in service after December 31, 1986.* The requirement in section 48(g)(2)(B)(i) and paragraph (c)(7)(i) of this section to use straight line cost recovery does not apply to any expenditure to the extent that the alternative depreciation system of section 168(g) applies to such expenditure by reason of section 168(g)(1) (B) or (C). In addition, the requirement in section 48(g)(2)(B)(i) and paragraph (c)(7)(i) of this section applies only to the depreciation of the portion of the basis of a

qualified rehabilitated building that is attributable to qualified rehabilitation expenditures. However, see §1.168(k)–1(f)(10) if the qualified rehabilitation expenditures are qualified property or 50-percent bonus depreciation property under section 168(k) and see §1.1400L(b)–1(f)(9) if the qualified rehabilitation expenditures are qualified New York Liberty Zone property under section 1400L(b).

(ii) *Property placed in service before January 1, 1987, and property placed in service after December 31, 1986, that qualifies for a transition rule.* In the case of expenditures attributable to property placed in service before January 1, 1987, and property that qualifies for the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, the term ''qualified rehabilitation expenditure'' does not include an expenditure with respect to which an election was not made under section 168(b)(3) as in effect prior to its amendment by the Tax Reform Act of 1986, to use the straight line method of depreciation. In such case, the requirement that an election be made to use straight line cost recovery applies only to the cost recovery of the portion of the basis of a qualified rehabilitated building that is attributable to qualified rehabilitation expenditures. See section 168(f)(1), as in effect prior to its amendment by the Tax Reform Act of 1986, for rules relating to the use of different methods of cost recovery for different components of a building. In addition, such requirement shall not apply to any expenditure to the extent that section 168(f)(12) or (j), as in effect prior to the amendments made by the Tax Reform Act of 1986, applied to such expenditure.

(9) *Cost of acquisition.* For purposes of paragraph (c)(7)(ii) of this section, cost of acquisition includes any interest incurred on indebtedness the proceeds of which are attributable to the acquisition of a building, an interest in a building, or land open which a building exists. Interest incurred on a construction loan the proceeds of which are used for qualified rehabilitation expenditures, however, is not treated as a cost of acquisition.

(10) *Enlargement defined*—(i) *In general.* A building is enlarged to the extent that the total volume of the building is increased. An increase in floor space resulting from interior remodeling is not considered an enlargement. The total volume of a building is generally equal to the product of the floor area of the base of the building and the height from the underside of the lowest floor (including the basement) to the average height of the finished roof (as it exists or existed). For this purpose, floor area is measured from the exterior faces of external walls (other than shared walls that are external walls) and from the centerline of shared walls that are external walls.

(ii) *Rehabilitation that includes enlargement.* If expenditures for property only partially qualify as qualified rehabilitation expenditures because some of the expenditures are attributable to the enlargement of the building, the expenditures must be apportioned between the original portion of the building and the enlargement. The expenditures must be specifically allocated between the original portion of the building and the enlargement to the extent possible. If it is not possible to make a specific allocation of the expenditures, the expenditures must be allocated to each portion on some reasonable basis. The determination of a reasonable basis for an allocation depends on factors such as the type of improvement and how the improvement relates functionally to the building. For example, in the case of expenditures for an air-conditioning system or a roof, a reasonable basis for allocating the expenditures among the two portions generally would be the volume of the building, excluding the enlargement, served by the air-conditioning system or the roof relative to the volume of the enlargement served by the improvement.

(d) *Rules applicable to rehabilitations of certified historic structures*—(1) *Definition of certified historic structure.* The term ''certified historic structure'' means any building (and its structural components) that is—

(i) Listed in the National Register of Historic Places (''National Register''); or

(ii) Located in a registered historic district and certified by the Secretary of the Interior to the Internal Revenue

Service as being of historic significance to the district.

For purposes of this section, a building shall be considered to be a certified historic structure at the time it is placed in service if the taxpayer reasonably believes on that date the building will be determined to be a certified historic structure and has requested on or before that date a determination from the Department of Interior that such building is a certified historic structure within the meaning of this paragraph (d)(1)(i) or (ii) and the Department of Interior later determines that the building is a certified historic structure.

(2) *Definition of registered historic district.* The term ''registered historic district'' means any district that is—

(i) Listed in the National Register, or

(ii) (A) Designated under a statute of the appropriate State or local government that has been certified by the Secretary of the Interior to the Internal Revenue Service as containing criteria that will substantially achieve the purpose of preserving and rehabilitating buildings of historic significance to the district, and (B) certified by the Secretary of the Interior as meeting substantially all of the requirements for the listing of districts in the National Register.

(3) *Definition of certified rehabilitation.* The term ''certified rehabilitation'' means any rehabilitation of a certified historic structure that the Secretary of the Interior has certified to the Internal Revenue Service as being consistent with the historic character of the building and, where applicable, the district in which such building is located. The determination of the scope of a rehabilitation shall be made on the basis of all the facts and circumstances surrounding the rehabilitation and shall not be made solely on the basis of ownership. The Secretary of the Interior shall take all of the rehabilitation work performed as part of a single rehabilitation, including any post-certification work, into account in determining whether the rehabilitation complies with the Department of Interior standards for rehabilitation and whether the certification should be granted, revoked, or otherwise invalidated.

(4) *Revoked or invalidated certification.* If the Department of Interior revokes or otherwise invalidates a certification after it has been issued to a taxpayer, the basis attributable to rehabilitation of the decertified property shall cease to be section 38 property described in section 48(a)(1)(E). Such cessation shall be effective as of the date the activity giving rise to the revocation or invalidation commenced. See section 47 for the rules applicable to property that ceases to be section 38 property.

(5) *Special rule for certain buildings located in registered historic districts.* The exclusion in paragraph (c)(7)(iv) of this section does not apply to a building in a registered historic district if—

(i) Such building was not a certified historic structure during the rehabilitation process; and

(ii) The Secretary of the Interior certified to the Internal Revenue Service that such building was not of historic significance to the district.

In general, the certification referred to in paragraph (d)(5)(ii) of this section must be requested by the taxpayer prior to the time that physical work on the rehabilitation began. If, however, the certification referred to in paragraph (d)(5)(ii) of this section is requested by the taxpayer after physical work on the rehabilitation of the building has begun, the taxpayer must certify to the Internal Revenue Service that, prior to the date that physical work on the rehabilitation began, the taxpayer in good faith was not aware of the requirement of paragraph (d)(5)(ii) of this section. The certification referred to in the previous sentence must be attached to the Form 3468 filed with the tax return for the year in which the credit is claimed.

(6) *Special rule for certain rehabilitations begun before an area is designated as a registered historic district.* In general, the exclusion from the definition of qualified rehabilitation expenditure in paragraph (c)(7)(iv) of this section applies to any rehabilitation expenditures that are incurred after a building becomes a certified historic structure within the meaning of section 48 (g)(3)A) and paragraph (d)(1) of this section or the area in which a building is located becomes a registered historic district within the meaning of section

48 (g)(3)(B) and paragraph (d)(2) of this section. Rehabilitation expenditures incurred prior to such date, however, are not disqualified. In addition, rehabilitation expenditures made after the date the area in which a building is located becomes a registered historic district shall not be disqualified under paragraph (c)(7)(iv) of this section in any case in which physical work on the rehabilitation of a building begins prior to the date the taxpayer knows or has reason to know of an intention to nominate the area in which such building is located as a registered historic district. For purposes of this paragraph (d)(6), the taxpayer knows or has reason to know of such an intention if there is (A) a communication (written or oral) to the owner of any building within the district from the Department of the Interior, or any agency or instrumentality of the appropriate state or local government (or a designee of such agency or instrumentality) that the district in which the building is located is being considered for designation as a registered historic district, (B) a legal notice of such consideration published in a newspaper, or (C) a public meeting held to discuss such consideration. In order to take advantage of the special rule of this paragraph (d)(6), the taxpayer must attach to the Form 3468 filed for the taxable year in which the credit is claimed a statement that the taxpayer in good faith did not know, or have reason to know, of an intention to nominate the area in which the building is located as a registered historic district.

(7) *Notice of certification*—(i) *In general*. Except as otherwise provided in paragraph (d)(7)(ii) of this section, a taxpayer claiming the credit for rehabilitation of a certified historic structure (within the meaning of section 48(g)(3) and paragraph (d)(1) of this section) must attach to the Form 3468 filed with the tax return for the taxable year in which the credit is claimed a copy of the final certification of completed work by the Secretary of the Interior, and for returns filed after January 9, 1989, evidence that the building is a certified historic structure.

(ii) *Late certification*. If the final certification of completed work has not been issued by the Secretary of the Interior at the time the tax return is filed for a year in which the credit is claimed, a copy of the first page of the Historic Preservation Certification Application—Part 2—Description of Rehabilitation (NPS Form 10–168a), with an indication that it has been received by the Department of the Interior or its designate, together with proof that the building is a certified historic structure (or that such status has been requested), must be attached to the Form 3468 filed with the return. A notice from the Department of the Interior or the State Historic Preservation Officer, stating that the nomination or application has been received, or a date-stamped nomination or application shall be sufficient indication that the nomination or application has been received. The building need not be either listed in the National Register or be determined to be of historic significance to a registered historic district at the time the return is filed for the year in which the credit is claimed. (See paragraph (d)(1) of this section.) The taxpayer must submit a copy of the final certification as an attachment to Form 3468 with the first income tax return filed after the receipt by the taxpayer of the certification. If the final certification is denied by the Department of Interior, the credit will be disallowed for any taxable year in which it was claimed. If the taxpayer fails to receive final certification of completed work prior to the date that is 30 months after the date that the taxpayer filed the tax return on which the credit was claimed, the taxpayer must submit a written statement to the District Director stating such fact prior to the last day of the 30th month, and the taxpayer shall be requested to consent to an agreement under section 6501(c)(4) extending the period of assessment for any tax relating to the time for which the credit was claimed. The procedure permitted by the preceding sentence shall be used whenever the entire rehabilitation project is not fully completed by the date that is 30 months after the taxpayer filed the tax return upon which the credit was claimed (e.g., a phased rehabilitation) and the Secretary of the Interior has thus not yet certified the rehabilitation.

(iii) *Effective dates.* Paragraph (d)(7)(i) of this section applies to returns for taxable years beginning before January 1, 2002. The requirement in the fourth sentence of paragraph (d)(7)(ii) of this section applies only if the first income tax return filed after receipt by the taxpayer of the certification is for a taxable year beginning before January 1, 2002. For rules applicable to returns for taxable years beginning after December 31, 2001, see paragraph (d)(7)(iv) of this section.

(iv) *Returns for taxable years beginning after December 31, 2001*—(A) *In general.* Except as otherwise provided in paragraph (d)(7)(ii) of this section and this paragraph (d)(7)(iv), a taxpayer claiming the credit for rehabilitation of a certified historic structure (within the meaning of section 47(c)(3) and paragraph (d)(1) of this section) for a taxable year beginning after December 31, 2001, must provide with the return for the taxable year in which the credit is claimed, the NPS project number assigned by, and the date of the final certification of completed work received from, the Secretary of the Interior. If a credit (including a credit for a taxable year beginning before January 1, 2002) is claimed under the late certification procedures of paragraph (d)(7)(ii) of this section and the first income tax return filed by the taxpayer after receipt of the certification is for a taxable year beginning after December 31, 2001, the taxpayer must provide the NPS project number assigned by, and the date of the final certification of completed work received from, the Secretary of the Interior with that return.

(B) *Reporting and recordkeeping requirements.* The information required under paragraph (d)(7)(iv)(A) of this section must be provided on Form 3468 (or its successor) filed with the taxpayer's return. In addition, the taxpayer must retain a copy of the final certification of completed work for as long as its contents may become material in the administration of any internal revenue law.

(C) *Passthrough entities.* In the case of a credit for qualified rehabilitation expenditures of a partnership, S corporation, estate, or trust, the requirements of this paragraph (d)(7)(iv) apply only to the entity. Each partner, shareholder or beneficiary claiming a credit for such qualified rehabilitation expenditures from a passthrough entity must, however, provide the employer identification number of the entity on Form 3468 (or its successor).

(e) *Adjustment to basis*—(1) *General rule.* Except as otherwise provided by this paragraph (e), if a credit is allowed with respect to property attributable to qualified rehabilitation expenditures incurred in connection with the rehabilitation of a qualified rehabilitated building, the increase in the basis of the rehabilitated property that would otherwise result from the qualified rehabilitation expenditures must be reduced by the amount of the credit allowed. See section 48(q) and the regulations there under for other rules concerning adjustments to basis in the case of section 38 property.

(2) *Special rule for certain property relating to certified historic structures.* If a rehabilitation investment credit is allowed with respect to property that is placed in service before January 1, 1987, or property that qualifies for the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, and such property is attributable to qualified rehabilitation expenditures incurred in connection with the rehabilitation of a certified historic structure, the increase in the basis of the rehabilitated property that would otherwise result from the qualified rehabilitation expenditures must be reduced by one-half of the amount of the credit allowed.

(3) *Recapture of rehabilitation investment credit.* If during any taxable year there is a recapture amount determined with respect to any credit that resulted in a basis adjustment under paragraph (e) (1) or (2) of this section, the basis of such building (immediately before the event resulting in such recapture) shall be increased by an amount equal to such recapture amount. For purposes of the preceding sentence, the term ''recapture amount'' means any increase in tax (or adjustment in carrybacks or carryovers) determined under section 47(a)(5).

(f) *Coordination with other provisions of the Code*—(1) *Credit claimed by lessee for rehabilitation performed by lessor.* A lessee may take the credit for rehabilitation performed by the lessor if the requirements of this section and section 48(d) are satisfied. For purposes of applying section 48(d), the fair market value of section 38 property described in section 48(a)(1)(E) shall be limited to that portion of the lessor's basis in the qualified rehabilitated building that is attributable to qualified rehabilitation expenditures. In the case of a portion of a building that is divided into more than one leasehold interest, the qualified rehabilitation expenditures attributable to the common elements shall be allocated to the individual leasehold interests in accordance with the principles of paragraph (c)(10)(ii) of this section. Furthermore, a leasehold interest's share of the common elements shall not be considered to have been placed in service prior to the time that the particular leasehold interest is placed in service.

(2) *When the credit may be claimed*—(i) *In general.* The investment credit for qualified rehabilitation expenditures is generally allowed in the taxable year in which the property attributable to the expenditure is placed in service, provided the building is a qualified rehabilitated building for the taxable year. See paragraph (b) of this section and section 46(c) and §1.46–3(d). Under certain circumstances, however, the credit may be available prior to the date the property is placed in service. See section 46(d) and §1.46–5 (relating to qualified progress expenditures). Solely for purposes of section 46(c), property attributable to qualified rehabilitation expenditures will not be treated as placed in service until the building with respect to which the expenditures are made meets the definition of a qualified rehabilitated building (as defined in section 48(g)(1) and paragraph (b) of this section) for the taxable year. Accordingly, in the first taxable year for which the building becomes a qualified rehabilitated building, the property described in section 48(a)(1)(E) attributable to expenditures described in paragraph (c) of this section, shall be considered to be placed in service, if such property was considered placed in service under section 46(c) and the regulations thereunder without regard to this paragraph (f)(2)(i) in that taxable year or a prior taxable year. For purposes of the preceding sentence, the requirement of section 48(g)(1)(A)(iii) and paragraph (b)(3) of this section, relating to the definition of a qualified rehabilitated building shall be deemed to be met if the taxpayer reasonably expects that no rehabilitation work undertaken during the remainder of the rehabilitation process will result in a failure to satisfy the requirements of paragraph (b)(3) of this section. If the requirements of paragraph (b)(3) of this section, are not satisfied, however, the credit shall be disallowed for the taxable year in which it was claimed. If a taxpayer fails to complete physical work on the rehabilitation prior to the date that is 30 months after the date that the taxpayer filed a tax return on which the credit is claimed, the taxpayer must submit a written statement to the District Director stating such fact prior to the last day of the 30th month, and shall be requested to consent to an agreement under section 6501(c)(4) extending the period of assessment for any tax relating to the item for which the credit was claimed.

(ii) *Section 38 property described in section 48(a)(1)(E).* In the case of section 38 property described in section 48(a)(1)(E), the section 38 property is not the building. Instead, the section 38 property is the portion of the basis of the building that is attributable to qualified rehabilitation expenditures. Therefore, for example, for purposes of the determination of when such section 38 property is placed in service, a determination must be made regarding when property attributable to the portion of the basis of the building attributable to qualified rehabilitation expenditures is placed in service. The issue of when the building is placed in service is thus not relevant. In fact, under this test, the building itself may never have been taken out of service during the rehabilitation process. If the building is rehabilitated over several years in stages (e.g., by floors), section 38 property attributable to qualified rehabilitation expenditures to a qualified rehabilitated building placed in service in each taxable year shall, generally, be treated as a separate item of section 38 property.

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

Example. Assume that A, a calendar year taxpayer, purchases a four-story building on January 1, 1983, for $100,000, and incurs $10,000 of qualified rehabilitation expenditures in 1983 to rehabilitate floor one, $50,000 of qualified rehabilitation expenditures in 1984 to rehabilitate floor two, $70,000 of qualified rehabilitation expenditures in 1985 to rehabilitate floor three, and $60,000 of qualified rehabilitation expenditures in 1986 to rehabilitate floor four. Assume further that A places the property attributable to these expenditures in service on the last day of the year in which the respective expenditures were incurred and that the building is never taken out of service since as each floor is rehabilitated, the other three floors are occupied by tenants. Under the rule in this paragraph (f)(2), the portion of the basis of the building that is attributable to qualified rehabilitation expenditures incurred with respect to floor one and two are deemed to be placed in service in 1985, because that is the first year that the substantial rehabilitation test described in paragraph (b) of this section is met ($120,000 of expenditures incurred by A during a measuring period ending on December 31, 1985 is greater than the $110,000 basis at the beginning of the period). Assume that as of December 31, 1985, at least 75 percent of the external walls of the building have been retained during the rehabilitation process and that A has a reasonable expectation that no work during the remainder of the rehabilitation process will result in less than 75 percent of the external walls being retained. A may claim a credit for A's 1985 taxable year on $130,000 of qualified rehabilitation expenditures ($10,000 in 1983, $50,000 in 1984, and $70,000 in 1985). (See paragraph (c)(6) of this section for rules applicable to when qualified expenditures may be incurred. In addition, see section 46 (d) and §1.46–5 for rules relating to qualified progress expenditures.) The fact that the building was a qualified rehabilitated building for A's 1985 taxable year, however, has no effect on whether the building is a qualified rehabilitated building for A's 1986 taxable year. In order to determine whether A is entitled to claim a credit on A's 1986 return for the $60,000 of qualified rehabilitation expenditures incurred in 1986, A must select a measuring period ending in 1986 and must determine whether the building is a qualified rehabilitated building for that year. Solely for purposes of determining whether the building was substantially rehabilitated, expenditures incurred in 1984 and 1985, even though considered in determining whether the building was substantially rehabilitated for A's 1985 taxable year, may be used in addition to the expenditures incurred in 1986 to determine whether the building was substantially rehabilitated for A's 1986 taxable year, provided the expenditures were incurred during any measuring period selected by A that ends in 1986.

(3) *Coordination with section 47.* If property described in section 48(a)(1)(E) is disposed of by the taxpayer, or otherwise ceases to be ''section 38 property,'' section 47 may apply. Property will cease to be section 38 property, and therefore section 47 may apply, in any case in which the Department of Interior revokes or otherwise invalidates a certification of rehabilitation after the property is placed in service or a building (other than a certified historic structure) is moved from the place where it is rehabilitated after the property is placed in service. If, for example, the taxpayer made modifications to the building inconsistent with Department of Interior standards, the Secretary of the Interior might revoke the certification. In addition, if all or a portion of a substantially rehabilitated building becomes tax-exempt use property (see paragraph (c)(7)(vi) of this section) for the first time within five years after the credit is claimed, the credit will be recaptured under section 47 at that time as if the building or portion of the building which becomes tax-exempt use property had then been sold.

(g) *Effective/applicability date.* This section applies on and after January 19, 2017. For rules before January 19, 2017, see §1.48–12 as contained in 26 CFR part 1 revised as of April 1, 2016.

[T.D. 8233, 53 FR 39592, Oct. 11, 1988; 53 FR 43866, Oct. 31, 1988, as amended by T.D. 8989, 67 FR 20030, Apr. 24, 2002; T.D. 9040, 68 FR 4920, Jan. 31, 2003; T.D. 9283, 71 FR 51737, Aug. 31, 2006; T.D. 9811, 82 FR 6236, Jan. 19, 2017]

§ 1.50–1 Lessee's income inclusion following election of lessor of investment credit property to treat lessee as acquirer.

(a) through (f) [Reserved]. For further guidance, see §1.50–1T(a) through (f).

[T.D. 9776, 81 FR 47704, July 22, 2016]

§ 1.50–1T Lessee's income inclusion following election of lessor of investment credit property to treat lessee as acquirer (temporary).

(a) *In general.* Section 50(d)(5) provides that, for purposes of computing the investment credit, rules similar to the rules of former section 48(d) (relating to certain leased property) (as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990 (Pub. L. 101–508, 104 Stat. 1388 (November 5, 1990))) apply. This section provides rules similar to the rules of former section 48(d)(5) that the Secretary has determined shall apply for purposes of determining the inclusion in gross income required when a lessor elects to treat a lessee as having acquired investment credit property.

(b) *Coordination with basis adjustment rules.* In the case of any property with respect to which an election is made under §1.48–4 by a lessor of investment credit property to treat the lessee as having acquired the property—

(1) *Basis adjustment.* Section 50(c) does not apply with respect to such property.

(2) *Amount of credit included ratably in gross income*—(i) *In general.* A lessee of the property must include ratably in gross income, over the shortest recovery period which could be applicable under section 168 with respect to that property, an amount equal to the amount of the credit determined under section 46 with respect to that property. The ratable income inclusion under this paragraph begins on the date the investment credit property is placed in service and continues on each one year anniversary date thereafter until the end of the applicable recovery period. The lessee will include in gross income the amount of its credit determined under section 46 regardless of limitations on the amount of the credit allowed under section 38(c) based on the amount of the lessee's income tax.

(ii) *Special rule for the energy credit.* In the case of any energy credit determined under section 48(a), paragraph (b)(2)(i) of this section applies only to the extent of 50 percent of the amount of the credit determined under section 46.

(3) *Special rule for partnerships and S corporations*—(i) *In general.* For purposes of paragraph (b)(2) of this section, if the lessee of the property is a partnership (other than an electing large partnership) or an S corporation, the gross income includible under such paragraph is not an item of partnership income to which the rules of subchapter K of Chapter 1, subtitle A of the Code apply or an item of S corporation income to which the rules of subchapter S of Chapter 1, subtitle A of the Code apply. Any partner or S corporation shareholder that is an ultimate credit claimant (as defined in paragraph (b)(3)(ii) of this section) is treated as a lessee that must include in gross income the amounts required under paragraph (b)(2) of this section in proportion to the credit determined under section 46 with respect to such partner or S corporation shareholder.

(ii) *Definition of ultimate credit claimant.* For purposes of this section, the term *ultimate credit claimant* means any partner or S corporation shareholder that files (or that would file) Form 3468, ''Investment Credit,'' with such partner's or S corporation shareholder's income tax return to claim an investment credit determined under section 46 with respect to such partner or S corporation shareholder.

(c) *Coordination with the recapture rules*—(1) *In general.* If section 50(a) requires an increase in the lessee's or the ultimate credit claimant's tax or a reduction in the carryback or carryover of an unused credit (or both) as a result of an early disposition (including a lease termination), etc., of leased property for which an election had been made under §1.48–4, the lessee or the ultimate credit claimant is required to include in gross income an amount equal to the excess, if any, of the amount of the credit that is not recaptured over the total increases in gross income previously made under paragraph (b)(2) of this section with respect to the property. Such amount is in addition to the amounts the lessee or the ultimate credit claimant previously included in gross income under paragraph (b)(2) of this section.

(2) *Income inclusion exceeds unrecaptured credit.* If section 50(a) requires an increase in the lessee's or ultimate credit claimant's tax or a reduction in the carryback or carryover of an unused credit (or both) as a result of an early disposition (including a lease termination), etc., of leased property for which an election had been made under § 1.48–4, the lessee's or the ultimate credit claimant's gross income shall be reduced by an amount equal to the excess, if any, of the total increases in gross income previously included under paragraph (b)(2) of this section over the amount of the credit that is not recaptured.

(3) *Special rule for the energy credit.* In the case of any energy credit determined under section 48(a), paragraphs (c)(1) and (2) of this section apply by substituting the phrase ''50 percent of the amount of the credit that is not recaptured'' for the phrase ''the amount of the credit that is not recaptured.''

(4) *Timing of income inclusion or reduction following recapture.* Any adjustment required by paragraphs (c)(1) and (2) of this section is taken into account in the taxable year in which the property is disposed of or otherwise ceases to be investment credit property.

(d) *Election to accelerate income inclusion outside of the recapture period*—(1) *In general.* If after the recapture period described in section 50(a), but prior to the expiration of the recovery period described in paragraph (b)(2) of this section, there is a lease termination, the lessee otherwise disposes of the lease, or a partner or S corporation shareholder that is an ultimate credit claimant disposes of its entire interest, either direct or indirect, in a lessee partnership (other than an electing large partnership) or S corporation, the lessee, or, in the case of a partnership or S corporation, the ultimate credit claimant may irrevocably elect to take into account the remaining amount required to be included in gross income under this section in the taxable year of the disposition or termination.

(2) *Exceptions.* The election provided under paragraph (d)(1) of this section is not available to—

(i) Lessees or ultimate credit claimants required by paragraph (c) of this section to account for the remaining amount required to be included in gross income after accounting for recapture in the taxable year in which the property was disposed of or otherwise ceased to be investment credit property under section 50(a); or

(ii) Former partners or S corporation shareholders that own no interest, either direct or indirect, in a lessee partnership or S corporation at the time of a lease termination or disposition.

(3) *Manner and time for making election.* The election under paragraph (d)(1) of this section is made by including the remaining amount required to be included under this section in gross income in the taxable year of the lease termination or disposition or the disposition of the ultimate credit claimant's entire interest, either direct or indirect, in a partnership or S corporation. The election must be made on or before the due date (including any extension of time) of the lessee's income tax return, or, in the case of a partnership or S corporation, the ultimate credit claimant's income tax return for the taxable year in which the lease termination or disposition or the disposition of the ultimate credit claimant's entire interest, either direct or indirect, in a partnership or S corporation occurs.

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

Example 1. X, a calendar year C corporation, leases nonresidential real property from Y. The property is placed in service on October 1, 2016. Y elects under § 1.48–4 to treat X as having acquired the property. X's investment credit determined under section 46 for 2016 with respect to such property is $9,750. The shortest recovery period that could be available to the property under section 168 is 39 years. Because Y has elected to treat X as having acquired the property, Y does not reduce its basis in the property under section 50(c). Instead, X, the lessee of the property, must include ratably in gross income over 39 years an amount equal to the credit determined under section 46 with respect to such property. Under paragraph (b)(2) of this section, X's increase in gross income for each of the 39 years beginning with 2016 is $250 ($9,750/39 year recovery period).

Example 2. The facts are the same as in *Example 1* of this paragraph (e), except that instead of nonresidential real property, X leases from Y solar energy equipment for which an energy credit under section 48 is determined under section 46. X's investment credit determined under section 46 for 2016 with respect to the property is $9,750. The shortest recovery period that could be available to the property under section 168 is 5 years. X, the lessee of the property, must include ratably in gross income over 5 years an amount equal to 50% of the credit determined under section 46 with respect to such property. Under paragraph (b)(2) of this section, X's increase in gross income for each of the 5 years beginning with 2016 is $975 ($4,875/5 year recovery period).

Example 3. A and B, calendar year taxpayers, form a partnership, the AB partnership, that leases nonresidential real property from Y. The property is placed in service on October 1, 2016. Y elects under §1.48–4 to treat the AB partnership as having acquired the property. A's investment credit determined under section 46 for 2016 is $3,900 and B's investment credit determined under section 46 for 2016 is $7,800 with respect to the property. The shortest recovery period that could be available to the property under section 168 is 39 years. Because Y has elected to treat the AB partnership as having acquired the property, Y does not reduce its basis in the building under section 50(c). Instead, A and B, the ultimate credit claimants, must include the amount of the credit determined with respect to A and B under section 46 ratably in gross income over 39 years, the shortest recovery period available with respect to such property. Therefore, A and B must include ratably in gross income over 39 years under paragraph (b)(2) of this section an amount equal to $3,900 and $7,800, respectively. Under paragraph (b)(2) of this section, A's increase in gross income for each of the 39 years beginning with 2016 is $100 ($3,900/39 year recovery period) and B's is $200 ($7,800/39 year recovery period). Because the gross income A and B are required to include under paragraph (b)(2) of this section is not an item of partnership income, the rules under subchapter K applicable to items of partnership income do not apply with respect to such income. In particular, A and B are not entitled to an increase in the outside basis of their partnership interests under section 705(a) and are not entitled to an increase in their capital accounts under section 704(b).

Example 4. The facts are the same as in *Example 3* of this paragraph (e), except that on January 1, 2019, the lease between AB partnership and Y terminates (Y retains ownership of the property), which is a recapture event under section 50(a). A's and B's income tax for 2019 is increased under section 50(a) by $2,340 and $4,680, respectively (60% of $3,900 and $7,800, respectively, assuming that the aggregate decrease in the credits allowed under section 38 was the full amount of the investment credits determined as to A and B under section 46). Therefore, the amount of the unrecaptured credit as to A and B is $1,560 and $3,120, respectively (40% of $3,900 and $7,800, respectively). The amounts that A and B previously included in gross income under paragraph (b)(2) of this section are $300 ($100 for each of 2016, 2017, and 2018) and $600 ($200 for each of 2016, 2017, and 2018), respectively. A and B are required under paragraph (c)(1) of this section to include in gross income an amount equal to the excess of the credit that is not recaptured ($1,560 and $3,120, respectively) over the total increases in gross income previously made under paragraph (b)(2) of this section with respect to the property ($300 and $600, respectively). Therefore, A and B must include in gross income $1,260 and $2,520, respectively, in the taxable year of the lease termination (2019) in addition to the recapture amounts described above.

Example 5. (i) The facts are the same as in *Example 4* of this paragraph (e), except that instead of nonresidential real property, the AB partnership leases from Y solar energy equipment for which an energy credit under section 48 is determined under section 46. Because the shortest recovery period that could be available to the property under section 168 is 5 years, A and B are required under paragraph (b)(2)(ii) of this section to include ratably in gross income over 5 years an amount equal to 50% of the credit determined under section 46 with respect to such property (50% of $3,900/5, or $390, per year for A, and 50% of $7,800/5, or $780, per year for B).

(ii) The January 1, 2019 lease termination requires A's and B's income tax for 2019 to be increased under section 50(a) by $2,340 and $4,680, respectively (60% of $3,900 and $7,800, respectively). Therefore, the amount of the unrecaptured credit as to A and B is $1,560 and $3,120, respectively (40% of $3,900 and $7,800, respectively). Under paragraph (b)(2)(ii) of this section, the amounts A and B previously included in gross income are $1,170 ($390 for each of 2016, 2017, and 2018) and $2,340 ($780 for each of 2016, 2017, and 2018), respectively. A and B are entitled to a reduction in gross income under paragraph (c)(2) of this section equal to the excess of the total increases in gross income made under paragraph (b)(2)(ii) of this section ($1,170 and $2,340, respectively) over 50% of the amount of the credit that is not recaptured ($780 and $1,560, respectively). Therefore, A and B are entitled to a reduction in gross income in the amount of $390 and $780, respectively, in the taxable year of the lease termination (2019).

Example 6. (i) The facts are the same as in *Example 3* of this paragraph (e), except that on December 1, 2021, A sells its entire interest to C, and on January 1, 2022, the lease between AB partnership and Y terminates. At the time of the lease termination, B is still a partner in the AB partnership. There is no recapture event under section 50(a) because both the lease termination and the disposition of A's interest in the partnership occurred outside of the recapture period.

(ii) At the time that A sold its interest in the AB partnership to C, A had previously included $500 ($100 for each of 2016–2020) in gross income under paragraph (b)(2) of this section. Under paragraph (b)(2) of this section, A must continue to include the remaining $3,400 (including $100 in 2021) in gross income ratably over the remaining portion of the applicable recovery period of 39 years. Alternatively, under paragraph (d)(1) of this section, A may irrevocably elect to include the remaining $3,400 in gross income in the taxable year that A sold its entire interest in the AB partnership to C (2021). Pursuant to paragraph (d)(2) of this section, A cannot make this election in the taxable year of the lease termination (2022).

(iii) At the time of the lease termination, B had previously included $1,200 ($200 for each of 2016–2021) in gross income under paragraph (b)(2) of this section. Under paragraph (b)(2) of this section, B must continue to include the remaining $6,600 required in gross income ratably over the remaining portion of the applicable recovery period of 39 years. Alternatively, under paragraph (d)(1) of this section, B may irrevocably elect to include the remaining $6,600 in gross income in the taxable year of the lease termination (2022).

(f) *Applicability date.* This section applies to property placed in service on or after September 19, 2016.

(g) *Expiration date.* The applicability of this section will expire on or before July 19, 2019.

[T.D. 9776, 81 FR 47704, July 22, 2016; 81 FR 65541, Sept. 23, 2016]

RULES FOR COMPUTING CREDIT FOR EXPENSES OF WORK INCENTIVE PROGRAMS

§ 1.50A–1 Determination of amount.

(a) *In general.* Except as otherwise provided in this section and in § 1.50A–2, the amount of the work incentive program (WIN) credit allowed by section 40 for the taxable year is equal to 20 percent of the taxpayer's WIN expenses (as determined under paragraph (a) of § 1.50B–1). The amount equal to 20 percent of the WIN expenses shall be referred to in this section and §§ 1.50A–2 through 1.50B–5 as the ''credit earned.''

(b) *Limitation based on amount of tax.* Notwithstanding the amount of the credit earned for the taxable year, under section 50A(a)(2) the credit allowed by section 40 for the taxable year is limited to—

(1) If the liability for tax (as defined in paragraph (c) of this section) is $25,000 or less, the liability for tax; or

(2) If the liability for tax is more than $25,000, then, the first $25,000 of the liability for tax plus 50 percent of the liability for tax in excess of $25,000. However, such $25,000 amount may be reduced in the case of certain married individuals filing separate returns (see paragraph (e) of this section); corporations which are members of a controlled group (see paragraph (f) of this section); estates and trusts (see paragraph (c) of § 1.50B–3); and organizations to which section 593 applies, regulated investment companies or real estate investment trusts subject to taxation under subchapter M, chapter 1 of the Code, and cooperative organizations described in section 1381(a) (see § 1.50B–5). The excess of the credit earned for the taxable year over the limitations described in this paragraph for such taxable year is an unused credit which may be carried back or forward to other taxable years in accordance with § 1.50A–2.

(c) *Liability for tax.* For the purpose of computing the limitation based on amount of tax, section 50A(a)(3) defines the liability for tax as the income tax imposed for the taxable year by chapter 1 of the Code, reduced by the sum of the credits allowable under—

(1) Section 33 (relating to taxes of foreign countries and possessions of the United States,

(2) Section 37 (relating to credit for the elderly),

(3) Section 38 (relating to investment in certain depreciable property), and

(4) Section 41 (relating to contributions to candidates for public office).

For purposes of this paragraph, the tax imposed for the taxable year by section 56 (relating to imposition of minimum tax for tax preferences), section 72(m)(5)(B) (relating to 10 percent tax on premature distributions to owner-employees), section 402(e) (relating to tax on lump sum distributions), section 408(f) (relating to additional tax on income from certain retirement accounts), section 531 (relating to imposition of accumulated earnings tax), section 541 (relating to imposition of personal holding company tax), or section 1378 (relating to tax on certain capital gains of subchapter S corporations), and any additional tax imposed for the taxable year by section 1351(d)(1) (relating to recoveries of foreign expropriation losses), shall not be considered tax imposed by chapter 1 of the Code for such year. Thus, the liability for tax for purposes of computing the limitation based on amount of tax for the taxable year is determined without regard to any tax imposed by sections 56, 72(m)(5)(B), 402(e), 408(f), 531, 541, 1351(d)(1) or 1378 of the Code. In addition, any increase in tax resulting from the application of section 50A (c) and (d) and §1.50A–3 (relating to recomputation of credit allowed due to early termination of employment by employer, or failure to pay comparable wages) shall not be treated as tax imposed by chapter 1 of the Code for purposes of computing the liability for tax. See section 50A (c)(3) and (d)(2).

(d) *Example.* The application of paragraphs (a), (b), and (c) of this section may be illustrated by the following example:

Example. X Corporation's WIN expenses for its taxable year ending December 31, 1973, are $500,000. X's credit earned for its taxable year is $100,000 (20 percent of $500,000). X's income tax for such year, computed without regard to credits against tax and without regard to any tax imposed by section 56, 531, 541, 1351(d)(1) or 1378, is $190,000. That amount includes $5,000 resulting from the application of section 50A(c)(3) and §1.50 A–3. X is allowed under section 33 a foreign tax credit of $50,000. X's liability for tax is computed as follows:

Income tax (including increase in tax under section 50A(c)(3), but before any credits and without regard to any tax imposed by section 56, 531, 541, 1351(d)(1) or 1378)		$190,000
Less:		
Increase in tax resulting from application of section 50A(c)(3)	$5,000	
Foreign tax credit	50,000	
		55,000
Liability for tax		135,000

Under section 50A(a)(2) and paragraph (b) of this section, X's limitation based on amount of tax for the taxable year is $80,000 ($25,000 plus 50 percent of $110,000). X Corporation's credit allowed by section 40 for the taxable year therefore is $80,000. X has an unused credit for the year of $20,000 ($100,000 less $80,000) which it may carry back or forward to other taxable years in accordance with §1.50A–2.

(e) *Married individuals.* If a separate return is filed by a husband or wife, the limitation based on amount of tax under paragraph (b) of this section shall be computed by substituting a $12,500 amount for the $25,000 amount in applying such paragraph (b). However, this reduction of the $25,000 amount to $12,500 applies only if the taxpayer's spouse is entitled to a credit under section 40 for the taxable year of such spouse which ends with, or within, the taxpayer's taxable year. The taxpayer's spouse is entitled to a credit under section 40 either because of incurring WIN expenses for such taxable year of the spouse (whether directly incurred by such spouse or whether apportioned to such spouse, for example, from an electing small business corporation, as defined in section 1371(b)), or because of a credit carryback or carryover to such taxable year under §1.50A–2. The determination of whether an individual is married shall be made under the principles of section 143 and the regulations thereunder.

(f) *Apportionment of $25,000 amount among component members of a controlled group*—(1) *In general.* In determining the limitation based on amount of tax under section 50A(a)(2) in the case of corporations which are component members of a controlled group of corporations on a December 31, only one $25,000 amount is available to such component members for their taxable years that include such December 31. See subparagraph (2) of this paragraph for apportionment of such amount among such component members. See subparagraph (3) of this paragraph for the definition of ''component member.''

(2) *Manner of apportionment.* (i) In the case of corporations which are component members of a controlled group on a particular December 31, the $25,000 amount may be apportioned among such members for their taxable years that include such December 31 in any manner the component members may select, provided that each such member less than 100 percent of whose stock is owned, in the aggregate, by the other component members of the group on

such December 31 consents to an apportionment plan. The consent of a component member to an apportionment plan with respect to a particular December 31 shall be made by means of a statement signed by a person duly authorized to act on behalf of the consenting member, stating that such member consents to the apportionment plan with respect to such December 31. The statement shall set forth the name, address, employer identification number, and taxable year of each component member of the group on such December 31, the amount apportioned to each such member under the plan, and the location of the Internal Revenue Service center where the statement is to be filed. The consent of more than one component member may be incorporated in a single statement. The statement shall be timely filed with the Internal Revenue Service center where the component member having the taxable year first ending on or after such December 31 files its return for such taxable year and shall be irrevocable after such filing. If two or more component members have the same such taxable year, a statement of consent may be filed by any one of such members. Such statement shall be considered as timely filed if filed on or before the due date (including any extensions of time) of such member's income tax return which includes such December 31. However, if the due date (including any extensions of time) of the return of such member is on or before December 15, 1972, the required statement shall be considered as timely filed if filed on or before March 15, 1973. Each component member of the group on such December 31 shall keep as a part of its records a copy of the statement containing all the required consents.

(ii) An apportionment plan adopted by a controlled group with respect to a particular December 31 shall be valid only for the taxable year of each member of the group which includes such December 31. Thus, a controlled group must file a separate consent to an apportionment plan with respect to each taxable year which includes a December 31 as to which an apportionment plan is desired.

(iii) If an apportionment plan is not timely filed, the $25,000 amount specified in section 50A(a)(2) shall be reduced for each component member of the controlled group, for its taxable year which includes a December 31, to an amount equal to $25,000 divided by the number of component members of each group on such December 31.

(iv) If a component member of the controlled group makes its income tax return on the basis of a 52–53 week taxable year, the principles of section 441(f)(2)(A)(ii) and paragraph (b)(1) of §1.441–2 apply in determining the last day of such taxable year.

(3) *Definitions of controlled group of corporations and component member of controlled group.* For the purpose of this paragraph, the terms ''controlled group of corporations'' and ''component member'' of a controlled group of corporations shall have the same meaning assigned to those terms in section 1563 (a) and (b) and the regulations thereunder. For purposes of applying §1.1563–1(b)(2)(ii)(*c*), an electing small business corporation shall be treated as an excluded member whether or not it is subject to the tax imposed by section 1378.

(4) *Members of a controlled group filing a consolidated return.* If some component members of a controlled group join in filing a consolidated return pursuant to §1.1502–3(a)(3), and other component members do not join, then, unless a consent is timely filed apportioning the $25,000 amount among the group filing the consolidated return and the other component members of the controlled group, each component member of the controlled group (including each component member which joins in filing the consolidated return) shall be treated as a separate corporation for purposes of equally apportioning the $25,000 amount under subparagraph (2)(iii) of this paragraph. In such case, the limitation based on the amount of tax for the group filing the consolidated return shall be computed by substituting for the $25,000 amount the total of the amount apportioned to each component member which joins in filing the consolidated return. If the affiliated group, filing the consolidated return and the other component members of the controlled group adopt an

apportionment plan, the affiliated group shall be treated as a single member for the purpose of applying subparagraph (2)(i) of this paragraph. Thus, for example, only one consent executed by the common parent to the apportionment plan is required for the group filing the consolidated return. If any component member of the controlled group which joins in the filing of the consolidated return is an organization to which section 593 applies or a cooperative organization described in section 1381(a), rules similar to the rules contained in paragraph (a)(3)(ii) of §1.1502–3 are applicable.

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

Example 1. At all times during 1972 Smith, an individual, owns all the stock of corporations X, Y, and Z. Corporation X files an income tax return on a calendar year basis. Corporation Y files an income tax return on the basis of a fiscal year ending June 30. Corporation Z files an income tax return on the basis of a fiscal year ending September 30. On December 31, 1972, X, Y, and Z are component members of the same controlled group. X, Y, and Z all consent to an apportionment plan in which the $25,000 amount is apportioned entirely to Y for its taxable year ending June 30, 1973 (Y's taxable year which includes December 31, 1972). Such consent is timely filed. For purposes of computing the credit under section 40, Y's limitation based on amount of tax for its taxable year ending June 30, 1973, is so much of Y's liability for tax as does not exceed $25,000, plus 50 percent of Y's liability for tax in excess of $25,000. X's and Z's limitations for their taxable years ending December 31, 1972, and September 30, 1973, respectively, are equal to 50 percent of X's liability for tax and 50 percent of Z's liability for tax. On the other hand, if an apportionment plan is not timely filed, X's limitation would be so much of X's liability for tax as does not exceed $8,333.33, plus 50 percent of X's liability in excess of $8,333.33, and Y's and Z's limitations would be computed similarly.

Example 2. At all times during 1972, Jones, an individual, owns all the outstanding stock of corporations P, Q, and R. Corporations Q and R both file returns for taxable year ending December 31, 1972. P files a consolidated return as a common parent for its fiscal year ending June 30, 1973, with its wholly owned subsidiaries N and O. On December 31, 1972, N, O, P, Q, and R are component members of the same controlled group. No consent to an apportionment plan is filed. Therefore, each member is apportioned $5,000 of the $25,000 amount ($25,000 divided equally among the five members). The limitation based on the amount of tax for the group filing the consolidated return (P, N, and O) for the year ending June 30, 1973 (the consolidated taxable year within which December 31, 1972, falls), is computed by using $15,000 instead of the $25,000 amount. The $15,000 is arrived at by adding together the $5,000 amounts apportioned to P, N, and O.

[38 FR 6152, Mar. 7, 1973, as amended by T.D. 7636, 44 FR 47049, Aug. 10, 1979]

§1.50A–2 Carryback and carryover of unused credit.

(a) *Allowance of unused credit as carryback or carryover*—(1) *In general.* Section 50A(b)(1) provides for carrybacks and carryovers of any unused credit. An unused credit is the excess of the credit earned for the taxable year (as determined under paragraph (a) of §1.50A–1) over the limitation based on amount of tax for such taxable year (as determined under paragraph (b) of §1.50A–1). Subject to the limitation contained in paragraph (b) of this section, an unused credit shall be added to the amount allowable as a credit under section 40 for the years to which the unused credit can be carried. The year with respect to which an unused credit arises shall be referred to in this section as the ‘‘unused credit year.’’

(2) *Taxable years to which unused credit may be carried.* An unused credit shall be a work incentive program (WIN) credit carryback to each of the 3 taxable years preceding the unused credit year and a WIN credit carryover to each of the 7 taxable years succeeding the unused credit year, except that an unused credit shall be a carryback only to taxable years beginning after December 31, 1971. An unused credit must be carried first to the earliest of the taxable years to which it may be carried, and then to each of the other taxable years (in order of time) to the extent that the unused credit may not be added (because of the limitation contained in paragraph (b) of this section) to the amount allowable as a credit under section 40 for a prior taxable year.

(b) *Limitation on allowance of unused credit.* The amount of the unused credit from any particular unused credit year which may be added to the amount allowable as a credit under section 40 for any of the preceding or succeeding taxable years to which such credit may be carried shall not exceed the amount by which the limitation based on amount of tax for such preceding or succeeding taxable year exceeds the sum of (1) the credit earned for such preceding or succeeding year, and (2) other unused credits carried to such preceding or succeeding year which are attributable to unused credit years prior to the particular unused credit year.

(c) *Corporate acquisitions*. For the carryover of unused credits in the case of certain corporate acquisitions, see section 381(c)(24) and the regulations thereunder. [§ 1.381(c)(24)–1]

(d) *Periods of less than 12 months*. A fractional part of a year which is considered as a taxable year under sections 441(b) and 7701(a)(23) shall be treated as a preceding or a succeeding taxable year for the purpose of determining under section 50A(b) and this section the taxable years to which an unused credit may be carried.

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

Example. Corporation X files its income tax return on the basis of the calendar year. X's credit earned and its limitation based on amount of tax for each of its taxable years 1972 through 1978 are as follows:

	Credit earned	Limitation based on amount of tax
1972	$175,000	$200,000
1973	250,000	160,000
1974	200,000	210,000
1975	210,000	230,000
1976	220,000	260,000
1977	260,000	220,000
1978	270,000	280,000

(i) Corporation X's credit earned for 1972, $175,000, is allowable in full as a credit under section 40 for 1972 since such amount is less than the limitation based on amount of tax for such year, $200,000. Since the limitation based on amount of tax for 1973 is $160,000, only $160,000 of the $250,000 credit earned for such year is allowable under section 40 as a credit for 1973. The unused credit for 1973 of $90,000 ($250,000 less $160,000) is a WIN credit carryback to 1972 and a WIN credit carryover to 1974 and subsequent years up to and including 1980. The portion of the $90,000 unused credit which shall be added to the amount allowable as a credit under section 40 for 1972 and 1974 and subsequent years is computed as follows:

(*a*) *1972*. The portion of the unused credit for 1973 ($90,000) which is allowable as a credit for 1972 is $25,000. This amount shall be added to the amount allowable as a credit for 1972. The balance of the unused credit for 1973 to be carried to 1974 is $65,000. These amounts are computed as follows:

Carryback to 1972			$90,000
1972 limitation based on tax		$200,000	
Less: Credit earned for 1972	$175,000		
Unused credits attributable to years preceding 1973	0		
		175,000	
Limit on amount of 1973 unused credit which may be added as a credit for 1972			25,000
Balance of 1973 unused credit to be carried to 1974			65,000

(*b*) *1974*. The portion of the balance of the unused credit for 1973 ($65,000) allowable as a credit for 1974 is $10,000. This amount shall be added to the amount allowable as a credit for 1974. The balance of the unused credit for 1973 to be carried to 1975 is $55,000. These amounts are computed as follows:

Carryover to 1974			$65,000
1974 limitation based on tax		$210,000	
Less: Credit earned for 1974	$200,000		
Unused credits attributable to years preceding 1973	0		
		200,000	
Limit on amount of 1973 unused credit which may be added as a credit for 1974			10,000
Balance of 1973 unused credit to be carried to 1975			55,000

(*c*) *1975*. The portion of the balance of the unused credit for 1973 ($55,000) allowable as a credit for 1975 is $20,000. This amount shall be added to the amount allowable as a credit for 1975. The balance of the unused credit for 1973 to be carried to 1976 is $35,000. These amounts are computed as follows:

Carryover to 1975			$55,000
1975 limitation based on tax		$230,000	
Less: Credit earned for 1975	$210,000		
Unused credits attributable to years preceding 1973	0		
		210,000	
Limit on amount of 1973 unused credit which may be added as a credit for 1975			$20,000
Balance of 1973 unused credit to be carried to 1976			35,000

(*d*) *1976.* The entire balance of the unused credit for 1973 ($35,000) is allowable as a credit for 1976, since the limitation based on amount of tax for 1976 exceeds the sum of the credit earned for 1976 and unused credits attributable to years prior to 1973 by an amount in excess of $35,000. Since the balance of the unused credit for 1973 has been fully allowed, no portion thereof remains to be carried to subsequent taxable years. This is illustrated as follows:

Carryover to 1976			$35,000
1976 limitation based on tax		$260,000	
Less: Credit earned for 1976	$220,000		
Unused credits attributable to years preceding 1973	0		
		220,000	
Limit on amount of 1973 unused credit which may be added as a credit for 1976			40,000
Balance of 1973 unused credit to be carried to 1977			0

(ii) Since the limitation based on amount of tax for 1977 is $220,000, only $220,000 of the $260,000 credit earned for such year is allowable as a credit for 1977. The unused credit for 1977 of $40,000 ($260,000 less $220,000) is a WIN credit carryback to 1974, 1975, and 1976 and a WIN credit carryover to 1978 and subsequent years. The portions of the $40,000 unused credit which shall be added to the amount allowable as a credit for such years are computed as follows:

(*a*) *1974.* The portion of the unused credit for 1977 ($40,000) allowable as a credit for 1974 is zero. The balance of the unused credit for 1977 to be carried to 1975 is $40,000. These amounts are computed as follows:

Carryback to 1974			$40,000
1974 limitation based on tax		$210,000	
Less: Credit earned for 1974	$200,000		
Unused credits attributable to years preceding 1977 (unused credit from 1973)	10,000		
		$210,000	
Limit on amount of 1977 unused credit which may be added as a credit for 1974			0
Balance of 1977 unused credit to be carried to 1975			40,000

(*b*) *1975.* The portion of the unused credit for 1977 ($40,000) allowable as a credit for 1975 is zero. The balance of the unused credit for 1977 to be carried to 1976 is $40,000. These amounts are computed as follows:

Carryback to 1975			$40,000
1975 limitation based on tax		$230,000	
Less: Credit earned for 1975	$210,000		
Unused credits attributable to years preceding 1977 (unused credit from 1973)	20,000		
		230,000	
Limit on amount of 1977 unused credit which may be added as a credit for 1975			0
Balance of 1977 unused credit to be carried to 1976			40,000

(*c*) *1976.* The portion of the unused credit for 1977 ($40,000) allowable as a credit for 1976 is $5,000. This amount shall be added to the amount allowable as a credit for 1976. The balance of the unused credit for 1977 to be carried to 1978 is $35,000. These amounts are computed as follows:

Carryback to 1976			$40,000
1976 limitation based on tax		$260,000	
Less: Credit earned for 1976	$220,000		
Unused credits attributable to years preceding 1977 (unused credit from 1973)	35,000		
		255,000	
Limit on amount of 1977 unused credit which may be added as a credit for 1976			5,000
Balance of 1977 unused credit to be carried to 1978			35,000

(*d*) *1978.* The portion of the balance of the unused credit for 1977 ($35,000) allowable as a credit for 1978 is $10,000. This amount shall be added to the amount allowable as a credit for 1978. The balance of the unused credit for 1977 to be carried to 1979 and subsequent years is $25,000. These amounts are computed as follows:

Carryover to 1978			$35,000
1978 limitation based on tax		$280,000	
Less: Credit earned for 1978	$270,000		
Unused credits attributable to years preceding 1977	0		
		$270,000	
Limit on amount of 1977 unused credit which may be added as a credit for 1978			$10,000
Balance of 1977 unused credit to be carried to 1979			25,000

(f) *Electing small business corporation.* An unused credit of a corporation which arises in an unused credit year for which the corporation is not an electing small business corporation (as defined in section 1371(b)) and which is a carryback or carryover to a taxable year for which the corporation is an electing small business corporation shall not be added to the amount allowable as a credit under section 40 to the shareholders of such corporation for any taxable year. However, a taxable year for which the corporation is an electing small business corporation shall be counted as a taxable year for purposes of determining the taxable years to which such unused credit may be carried.

[38 FR 6153, Mar. 7, 1973]

§ 1.50A–3 Recomputation of credit allowed by section 40.

(a) *General rule*—(1) *Early termination of employment by employer*—(i) *In general*. If the employment of any employee, with respect to whom work incentive program (WIN) expenses (as defined in paragraph (a) of § 1.50B–1) are taken into account under paragraph (a) of § 1.50A–1, is terminated by the taxpayer at any time during the first 12 months of such employment (whether or not consecutive) or before the close of the 12th calendar month after the calendar month in which such employee completes the first 12 months of employment (whether or not consecutive) with the taxpayer, then subparagraph (3) of this paragraph shall apply. See paragraph (c) of this section for rules relating to the determination of the first 12 months of employment (whether or not consecutive). See § 1.50A–4 for rules relating to other circumstances under which a termination of employment will not be treated as a termination of employment to which the provisions of subparagraph (3) of this paragraph are applicable.

(ii) *Rules for determining whether a termination of employment has occurred*. For purposes of this section, the taxpayer is deemed to have terminated the employment of any WIN employee (as defined in paragraph (h) of § 1.50B–1) if the employment relationship (as determined under common law principles) has terminated. A layoff for any reason is considered a termination of employment for purposes of the preceding sentence. However, a temporary suspension of employment of any WIN employee necessitated by the installation of new equipment or by the retooling of existing equipment (such as for a model changeover in the automobile industry) shall not be deemed to be a termination of employment if such suspension is for a period of time no longer than 60 days. For purposes of this section, the death of the taxpayer is considered a termination of the employment relationship between the taxpayer and any WIN employee.

(2) *Failure to pay comparable wages*—(i) *In general*. If, at any time during the period described in subparagraph (1)(i) of this paragraph, the taxpayer pays wages (as defined in section 50B(b) and paragraph (b) of § 1.50B–1) to an employee, with respect to whom WIN expenses are taken into account under paragraph (a) of § 1.50A–1, which are less than the wages paid to other employees of the taxpayer who perform comparable services, then subparagraph (3) of this paragraph shall apply.

(ii) *Comparable services*. (*a*) For purposes of subdivision (i) of this subparagraph, the term ''comparable services'' refers to services performed in work positions which require similar education, training, and skills. Comparable services are those associated with other work positions which require similar levels of judgment and responsibility, which make similar physical and mental demands of an employee, and which could easily be performed by the employee without substantial additional training or experience.

(*b*) If substantial training, skill, or experience are material to the performance of a particular job, a taxpayer may pay wages to a WIN employee which are less than those paid to other employees of the taxpayer who possess such training, skill, or experience. However, there must be a reasonable relationship between the lower wages or salary of such WIN employee and his relative lack of training, skill, or experience.

(3) *Recomputation of credit earned*. (i) If, by reason of subparagraph (1) or (2) of this paragraph, this subparagraph (3) is applicable, then the credit earned for all credit years (as defined in subdivision (ii)(*a*) of this subparagraph) shall be recomputed under the principles of paragraph (a) of § 1.50A–1 by not taking

into account WIN expenses with respect to the employee (or employees) described in subparagraph (1) or (2) of this paragraph. There shall be recomputed under the principles of §§1.50A–1 and 1.50A–2 the credit allowed for all credit years and for any other taxable year affected by reason of the reduction in credit earned for such credit year or years, giving effect to such reduction in the computation of carrybacks or carryovers of unused credit from any taxable year. If the recomputation described in the preceding sentence results, in the aggregate, in a decrease (taking into account any recomputation under this paragraph in respect of prior recapture years, as defined in subdivision (ii)(*b*) of this subparagraph) in the credits allowed for any credit year and for any other taxable year affected by the reduction in credit earned for any credit year, then the income tax for the recapture year shall be increased by the amount of such decrease in credits allowed. For treatment of such increase in tax, see paragraph (b) of this section. For special rules in the case of an electing small business corporation (as defined in section 1371(b)), an estate or trust, or a partnership, see respectively, §1.50A–5, §1.50A–6 or §1.50A–7.

(ii) For purposes of this section and §§1.50A–4 through 1.50B–6—

(*a*) The term ''credit year'' means a taxable year in which WIN expenses with respect to the employee described in subparagraph (1) or (2) of this paragraph are taken into account under paragraph (a) of §1.50A–1.

(*b*) The term ''recapture year'' means a taxable year in which a termination of employment (within the meaning of subparagraph (1) of this paragraph) or a failure to pay comparable wages (within the meaning of subparagraph (2) of this paragraph) occurs by reason of which the rule of subparagraph (3) of this paragraph becomes applicable.

(*c*) The term ''recapture determination'' means a recomputation made under this paragraph.

(b) *Increase in income tax and reduction of WIN credit carryback and carryover*—(1) *Increase in tax*. Except as provided in subparagraph (2) of this paragraph, any increase in income tax under this section shall be treated as income tax imposed on the taxpayer by chapter 1 of the Code for the recapture year notwithstanding that without regard to such increase the taxpayer has no income tax liability, has a net operating loss for such taxable year, or no income tax return was otherwise required for such taxable year.

(2) *Special rule*. Any increase in income tax under this section shall not be treated as income tax imposed on the taxpayer by chapter 1 of the Code for purposes of determining the amount of the credits allowable to such taxpayer under—

(i) Section 33 (relating to taxes of foreign countries and possessions of the United States),

(ii) Section 35 (relating to partially tax-exempt interest received by individuals),

(iii) Section 37 (relating to retirement income),

(iv) Section 38 (relating to investment in certain depreciable property),

(v) Section 39 (relating to certain uses of gasoline, special fuels, and lubricating oil),

(vi) Section 40 (relating to expenses of work incentive programs), and

(vii) Section 41 (relating to contributions to candidates for public office).

(3) *Reduction in credit allowed as a result of a net operating loss carryback*. (i) If a net operating loss carryback from the recapture year or from any taxable year subsequent to the recapture year reduces the amount allowed as a credit under section 40 for any taxable year up to and including the recapture year, then there shall be a new recapture determination under paragraph (a) of this section for each recapture year affected, taking into account the reduced amount of credit allowed after application of the net operating loss carryback.

(ii) Subdivision (i) of this subparagraph may be illustrated by the following example:

Example. (a) X Corporation, which makes its returns on the basis of a calendar year, hired WIN employees on March 1, 1972, and incurred $10,000 in WIN expenses with respect to these employees for the year. For the taxable year 1972, X Corporation's credit earned of $2,000 (20 percent of $10,000) was allowed under section 40 as a credit against its liability for tax of $2,000. In 1973 and 1974 X Corporation had no liability for tax and had no

WIN expenses. In January 1974, X Corporation terminated the employees for whom the WIN expenses had been incurred. Since these terminations were not subject to the exceptions provided by § 1.50A–4, there was a recapture determination under paragraph (a) of this section. The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1974 was increased by the $2,000 decrease in its credit earned for the taxable year 1972 (that is, the $2,000 original credit earned minus zero recomputed credit earned).

(b) For the taxable year 1975, X Corporation has a net operating loss which is carried back to the taxable year 1972 and reduces its liability for tax, as defined in paragraph (c) of § 1.50A–1, for such taxable year to $800. As a result of such net operating loss carryback, X Corporation's credit allowed under section 40 for the taxable year 1972 is limited to $800 and the excess of $1,200 ($2,000 credit earned minus the $800 limitation based on amount of tax) is a WIN credit carryover to the taxable year 1973.

(c) For 1975 there is a recapture determination under subdivision (i) of this subparagraph for the 1974 recapture year. The $2,000 increase in the income tax imposed on X Corporation for the taxable year 1974 is redetermined to be $800 (that is, the $800 credit allowed after taking into account the 1975 net operating loss minus zero credit which would have been allowed taking into account the 1974 recapture determination). In addition, X Corporation's $1,200 WIN credit carryover to the taxable year 1973 is reduced by $1,200 ($2,000 minus $800) to zero and X Corporation is entitled to a $1,200 refund of the $2,000 tax paid as a result of the 1974 recapture determination.

(4) *Statement of recomputation.* The taxpayer shall attach to his income tax return for the recapture year a separate statement showing in detail the computation of the increase in income tax imposed on such taxpayer by chapter 1 of the Code and the reduction in any WIN credit carryovers.

(c) *Period of employment*—(1) *Initial date of employment.* For purposes of this section and §§ 1.50A–4 through 1.50B–6, the initial date of employment (for purposes of applying paragraph (a) (1) and (2) of this section and paragraphs (a)(1) and (f) of § 1.50B–1) is the date the WIN employee reports to the taxpayer (or in the case where the taxpayer is a partner of a partnership, a beneficiary of an estate or trust, or a shareholder of an electing small business corporation, to such partnership, estate, trust, or electing small business corporation) for work.

(2) *Computation of the first 12 months of employment (whether or not consecutive).* For purposes of computing the first 12 months of employment (whether or not consecutive), the first month of employment shall begin with the initial date of employment (as defined in subparagraph (1) of this paragraph) of the WIN employee, the second month of employment shall begin with the corresponding date in the following month, the third month of employment shall begin with the corresponding date in the next following month, and so forth. If the WIN employee performs any services during any such month (as determined under the preceding sentence), that month shall be counted in computing the WIN employee's "first 12 months of employment (whether or not consecutive)". If the WIN employee performs no services during any such month, that month shall not be counted in computing the WIN employee's "first 12 months of employment (whether or not consecutive)". Thus, if the initial date of employment of a WIN employee is June 15, the first month of employment of such employee shall be the period beginning June 15, and ending July 14. The second month of employment is the period beginning July 15 and ending August 14. If during such second month of employment the employee performs no services for the taxpayer, that month is not counted in determining the employee's first 12 months of employment (whether or not consecutive).

[38 FR 6154, Mar. 7, 1973]

§ 1.50A–4 Exceptions to the application of § 1.50A–3.

(a) *In general.* Notwithstanding the provisions of paragraph (a) of § 1.50A–3, a termination of employment shall not be deemed to occur if paragraph (b) (relating to voluntary termination of employment), paragraph (c) (relating to termination of employment due to disability), paragraph (d) (relating to termination of employment due to misconduct), paragraph (f) (relating to transactions to which section 381(a) applies), or paragraph (g) (relating to mere change in form of conducting a trade or business) applies.

(b) *Voluntary termination of employment.* A termination of employment shall not be deemed to occur for purposes of paragraph (a) of §1.50A–3 if the employee voluntarily leaves the employment of the taxpayer. If the taxpayer makes the working conditions of the employee so untenable that the employee is, in effect, compelled by the taxpayer to quit, or if the employee is coerced into quitting, the employee will not be deemed to have voluntarily left the employment of the taxpayer. For purposes of the preceding sentence, a substantial reduction in the benefits of employment of an employee (such as a substantial decrease in the hours of the employee's working week) shall constitute untenable working conditions. An employee has voluntarily left the employment of the taxpayer if he leaves for any reason external to his employment, such as sickness or death in the employee's family which the employee feels necessitates his quitting work with the taxpayer to remain at home. Any employee who participates in an authorized strike (as finally determined by a court, labor relations administrative body, or arbiter) will not be deemed to have voluntarily left the employment of the taxpayer.

(c) *Termination of employment due to death or disability.* A termination of employment shall not be deemed to occur for purposes of paragraph (a) of §1.50A–3 if, after the initial date of employment (as defined in paragraph (c)(1) of §1.50A–3) and before the close of the period referred to in paragraph (a)(1) of §1.50A–3, the employee becomes disabled, by reason of illness or injury (including a disability relating to the employment), to perform the services required by such employment, unless, before the close of such period:

(1) Such disability is removed,

(2) The employer knows of the removal of the disability, and

(3) The employer fails to offer reemployment to such employee.

The death of an employee shall not be deemed a termination of employment for purposes of paragraph (a) of §1.50A–3.

(d) *Termination of employment due to misconduct.* A termination of employment shall not be deemed to occur for purposes of paragraph (a) of §1.50A–3 if it is determined by the appropriate State administrative agency or State court that under the applicable State unemployment compensation law such termination was due to the misconduct of the WIN employee. If the WIN employee is not covered by the applicable State unemployment compensation law (or if the employee did not work for the minimum period required to qualify for unemployment compensation or if the employee did not apply for unemployment compensation), a termination of employment shall not be deemed to occur for purposes of paragraph (a) of §1.50A–3 if the taxpayer demonstrates by convincing evidence that, were such employee covered by the applicable State unemployment compensation law (or if the employee had worked for such minimum period or if the employee had applied for unemployment compensation), he could reasonably have been found by such administrative agency or court to have been terminated for misconduct.

(e) *Recordkeeping requirement.* A taxpayer who is claiming that a termination of employment falls within the provisions of paragraph (b), (c), or (d) of this section shall maintain sufficient records to support his claim until the expiration of the pertinent period of limitations.

(f) *Transactions to which section 381(a) applies*—(1) *General rule.* The employment relationship between the taxpayer and a WIN employee (as defined in paragraph (h) of §1.50B–1) shall not be deemed terminated for purposes of paragraph (a) of §1.50A–3 in the case of a transaction to which section 381(a) (relating to carryovers in certain corporate acquisitions) applies. If there is a termination of employment (within the meaning of paragraph (a) of §1.50A–3 and this section) by the acquiring corporation with respect to the WIN employee described in the preceding sentence, or if the acquiring corporation fails to pay comparable wages to such employee (within the meaning of paragraph (a)(2) of §1.50A–3), then paragraph (a)(3) of §1.50A–3 shall apply to the acquiring corporation with respect to the credit allowed the acquired corporation as well as the credit allowed the acquiring corporation with respect to such employee. For purposes of the preceding sentence, the initial date of employment (as defined in paragraph (c)(1) of §1.50A–3) of such employee with respect to the acquired corporation shall be deemed to be the initial date of employment of such employee with respect to the acquiring corporation and employment by the acquired corporation shall be deemed employment by the acquiring corporation.

(2) *Examples.* This paragraph may be illustrated by the following examples:

Example 1. (i) X Corporation, a wholly owned subsidiary of Y Corporation, incurred WIN expenses of $12,000 for its taxable year ending December 31, 1972, with respect to WIN employees hired on March 1, 1972. Both X and Y made their returns on the basis of a calendar year. For the taxable year 1972 X Corporation's credit earned of $2,400 (20 percent of $12,000) was allowed under section 40 as a credit against its liability for tax. On December 15, 1973, X Corporation is liquidated under section 332 and all of its assets and liabilities are transferred to Y Corporation in a transaction to which section 334(b)(2) is not applicable. In addition, Y Corporation continues the employment of the WIN employees which were employed by X Corporation and with respect to which X Corporation was allowed the credit for its taxable year 1972.

(ii) Under subparagraph (1) of this paragraph, a termination of employment of the WIN employees shall not be deemed to occur for purposes of paragraph (a)(1) of §1.50A–3 due to the liquidation of X Corporation on December 15, 1973. Thus, no recapture determination under paragraph (a)(3) of §1.50A–3 shall be made with respect to X Corporation.

Example 2. (i) The facts are the same as in Example 1 and, in addition, on February 2, 1974, Y Corporation terminates the employment of the employees with respect to whom X Corporation had incurred WIN expenses. The termination is a termination for purposes of paragraph (a)(1) of §1.50A–3. For purposes of applying the period described in paragraph (a)(1) of §1.50A–3, the date the employees reported for work at X Corporation is deemed to be the initial date of employment of the employees with respect to Y Corporation.

(ii) Under subparagraph (1) of this paragraph, a termination of employment of the WIN employees shall not be deemed to occur for purposes of paragraph (a)(1) of §1.50A–3 due to the liquidation of X Corporation on December 15, 1973. However, a termination of employment of the WIN employees is deemed to occur for purposes of paragraph (a)(1) of §1.50A–3 on February 2, 1974. Thus, Y Corporation shall make a recapture determination under paragraph (a) of §1.50A–3 with respect to the credit allowed X Corporation with respect to the WIN employees.

(g) *Mere change in form of conducting a trade or business*—(1) *General rule.* (i) The employment relationship between the taxpayer and a WIN employee (as defined in paragraph (h) of §1.50B–1) shall not be deemed terminated for purposes of paragraph (a) of §1.50A–3 in the case of a mere change in the form of conducting the trade or business in which such employment occurs, provided that the conditions set forth in subdivision (ii) of this subparagraph are satisfied.

(ii) The conditions referred to in subdivision (i) of this subparagraph are as follows:

(*a*) The WIN employee described in subdivision (i) of this subparagraph is retained in the same trade or business,

(*b*) The taxpayer retains a substantial ownership interest in such trade or business,

(*c*) Substantially all the assets necessary to operate such trade or business are transferred to the transferee who continues the employment of the WIN employee described in subdivision (i) of this subparagraph, and

(*d*) The basis of the assets described in (*c*) of this subdivision in the hands of the transferee is determined in whole or in part by reference to the basis of such assets in the hands of the transferor.

This subparagraph shall not apply if paragraph (e) of this section (relating to transactions to which section 381(a) applies) is applicable with respect to such transfer.

(2) *Substantial interest.* For purposes of this paragraph, the taxpayer shall be considered as having retained a substantial ownership interest in the trade or business only if, after the change in form, the ownership interest in such trade or business by such taxpayer—

(i) Is substantial in relation to the total ownership interests of all persons, or

(ii) Is equal to or greater than the ownership interest prior to the change in form.

Thus, where a taxpayer owns a 5-percent interest in a partnership, and, after the incorporation of that partnership, the taxpayer retains at least a 5-

percent interest in the corporation, the taxpayer will be considered as having retained a substantial interest in the trade or business as of the date of the change in form because of the application of the rule contained in subdivision (ii) of this subparagraph.

(3) *Termination of employment.* (i) If employment of a WIN employee described in subparagraph (1)(i) of this paragraph is terminated by the transferee, the employment of such employee shall be deemed terminated by the taxpayer for purposes of paragraph (a) of §1.50A–3. For purposes of determining the period described in paragraph (a)(1) of §1.50A–3 with respect to such taxpayer employment by the transferee shall be deemed employment by the transferor.

(ii) If in any taxable year the taxpayer does not retain a substantial ownership interest in the trade or business directly or indirectly (through ownership in other entities provided that such other entities' bases in such interest are determined in whole or in part by reference to the basis of such interest in the hands of the taxpayer) then, for purposes of paragraph (a)(1) of §1.50A–3, there shall be deemed to be a termination of employment of the WIN employees described in subparagraph (1)(i) of this paragraph on the first date on which such taxpayer does not retain a substantial interest in the trade or business. For purposes of determining the period described in paragraph (a)(1) of §1.50A–3, employment by the transferee shall be deemed employment by the transferor. Any taxpayer who seeks to establish his interest in a trade or business under the rule of this subdivision shall maintain adequate records to demonstrate his indirect interest in such trade or business after any such transfer or transfers.

(iii) Notwithstanding subparagraph (1) of this paragraph and subdivision (ii) of this subparagraph in the case of a mere change in the form of a trade or business, if the interest of a taxpayer in the trade or business is reduced but such taxpayer has retained a substantial interest in such trade or business, paragraph (a)(2) of §1.50A–5 (relating to electing small business corporations), paragraph (a)(2) of §1.50A–6 (relating to estates or trusts), or paragraph (a)(2)(ii) of §1.50A–7 (relating to partnerships) shall apply, as the case may be.

(4) *Failure to pay comparable wages.* If the transferee fails to pay comparable wages (within the meaning of paragraph (a)(2) of §1.50A–3) to the WIN employee within the period described in paragraph (a)(1) of §1.50A–3, then such failure shall be deemed to be a failure of the transferor (or in a case where the transferor is a partnership, estate, trust, or electing small business corporation, the partners, beneficiaries, or shareholders), and a recapture determination shall be made with respect to such WIN employee as provided in §1.50A–3. For purposes of determining the period described in paragraph (a)(1) of §1.50A–3 with respect to such transferor (or such partners, beneficiaries, or shareholders), employment by the transferee shall be deemed employment by such transferor. For special rules in the case of an electing small business corporation (as defined in section 1371(b)), an estate or trust, or a partnership, see respectively, §1.50A–5, §1.50A–6, or §1.50A–7.

(5) *Examples.* This paragraph may be illustrated by the following examples in each of which it is assumed that the transfer satisfies the conditions of subparagraphs (1)(ii) (*a*), (*c*) and (*d*) of this paragraph.

Example 1. (i) On January 1, 1972, A, an individual, employed WIN employees in his sole proprietorship. A incurred WIN expenses with respect to these employees of $12,000 for the taxable year ending December 31, 1972. For the taxable year 1972 A's credit earned of $2,400 (20 percent of $12,000) was allowed under section 40 as a credit against his liability for tax. On March 15, 1973, A transferred all of the assets used in his sole proprietorship to X Corporation, a newly formed corporation, in exchange for 45 percent of the stock of X Corporation.

(i) Under subparagraph (1)(i) of this paragraph, paragraph (a) of §1.50A–3 does not apply to the March 15, 1973, transfer to X Corporation.

Example 2. (i) The facts are the same as in Example 1 and in addition on June 1, 1973, X Corporation terminates the employment of WIN employees with respect to whom 50 percent of the WIN expenses were incurred during A's 1972 taxable year.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a) of §1.50A–3 does not apply to the March 15, 1973, transfer to X Corporation. However, under subparagraph

(3)(i) of this paragraph, paragraph (a) of §1.50A–3 applies to the June 1, 1973, termination of WIN employees by X Corporation. The actual period of employment of such WIN employees is 1 year and 5 months (that is, the period beginning on January 1, 1972, and ending on June 1, 1973). For taxable year 1972, A's recomputed credit earned is $1,200 (20 percent of $6,000). The income tax imposed by chapter 1 of the Code on A for the taxable year 1973 is increased by the $1,200 decrease in his credit earned for the taxable year 1972 (that is, $2,400 original credit earned minus $1,200 recomputed credit earned).

Example 3. (i) The facts are the same as in Example 1 and in addition on April 1, 1973, X Corporation begins paying wages to the employees referred to in Example 1 which are less than the wages paid to its other employees who perform comparable services.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a)(1) of §1.50A–3 does not apply to the March 15, 1973, transfer to X Corporation. However, under subparagraph (4) of this paragraph, paragraph (a) of §1.50A–3 applies to the failure of X Corporation to pay wages to the WIN employees which are equal to the wages paid to its other employees who perform comparable services. For taxable year 1972, A's recomputed credit earned is zero. The income tax imposed by chapter 1 of the Code on A for the taxable year 1973 is increased by the $2,400 decrease in his credit earned for the taxable year 1972.

Example 4. (i) On January 1, 1972, partnership ABC, which makes its returns on the basis of a calendar year, employed WIN employees. Partnership ABC incurred WIN expenses with respect to these employees of $20,000 for the taxable year. Partnership ABC has 10 partners who make their returns on the basis of a calendar year and share partnership profits equally. Each partner's share of the WIN expenses is 10 percent, that is, $2,000. On March 15, 1973, partnership ABC transfers all of the assets used in its trade or business to the X Corporation, a newly formed corporation, in exchange for its stock and immediately thereafter transfers 10 percent of the stock to each of the 10 partners.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a)(1) of §1.50A–1 does not apply to the March 15, 1973, transfer by the ABC Partnership to X Corporation.

Example 5. (i) The facts are the same as in Example 4 except that partnership ABC transfers 10 percent of the stock in X Corporation to each of eight partners, 20 percent to partner A, and cash to partner B.

(ii) Under subparagraph (1)(i) of this paragraph, with respect to all of the partners (including partner A) except partner B, paragraph (a)(1) of §1.50A–3 does not apply to the March 15, 1973, transfer by the ABC Partnership. Paragraph (a)(1) of §1.50A–3 applies with respect to partner B's $2,000 share of the WIN expenses. See paragraph (a)(2) of §1.50A–7.

Example 6. (i) X Corporation operates a manufacturing business and a separate retail sales business. During the month of January 1972, X incurred WIN expenses in its manufacturing business. On February 10, 1973, X transfers all the assets used in its manufacturing business to Partnership XY in exchange for a 50 percent interest in such partnership.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a)(1) of §1.50A–3 does not apply to the February 10, 1973, transfer to Partnership XY.

[T.D. 7263, 38 FR 6156, Mar. 7, 1973; 38 FR 8656, Apr. 5, 1973]

§ 1.50A–5 Electing small business corporations.

(a) *In general*—(1) *Termination of employment by a corporation.* If an electing small business corporation (as defined in section 1371(b)) or a former electing small business corporation terminates (in a termination subject to the provisions of paragraph (a) of §1.50A–3) the employment of any WIN employee with respect to whom WIN expenses have been paid or incurred, a recapture determination shall be made under §1.50A–3 with respect to each shareholder who is treated, under paragraph (a) of §1.50B–2 as a taxpayer who paid or incurred such expenses. Each such recapture determination shall be made with respect to the pro rata share of the WIN expenses of such employee which were taken into account by such shareholder under paragraph (a) of §1.50B–2. For purposes of each such recapture determination the period of employment of such employee or employees shall be the period beginning with the initial date of employment (as defined in paragraph (c)(1) of §1.50A–3) with respect to the electing small business corporation and ending with the date of such employee's termination (as defined in paragraph (a)(1)(ii) of §1.50A–3). For the definition of the term ''recapture determination'' see paragraph (a)(3) of §1.50A–3.

(2) *Disposition of shareholder's interest.* (i) If—

(*a*) WIN expenses are apportioned to a shareholder of an electing small business corporation who takes such expenses into account in computing his WIN expenses, and (*b*) After the end of the shareholder's taxable year in which such apportionment was taken into account and before the close of the period to which paragraph (a)(1) of §1.50A–3 applies with respect to the employee to which such WIN expenses relate, such shareholder's proportionate stock interest in such corporation is reduced (for example, by a sale or redemption, or by the issuance of additional shares) below the percentage specified in subdivision (ii) of this subparagraph,

then, on the date of such reduction the employment of such employee shall be deemed terminated with respect to such shareholder to the extent of the actual reduction in such shareholder's proportionate stock interest. (For example, if $100 of WIN expenses were apportioned to a shareholder and if his proportionate stock interest is reduced from 60 percent to 30 percent (that is, 50 percent of his original interest), then the employment of the employee to which such WIN expenses relate shall be deemed terminated as to that shareholder to the extent of $50.) Accordingly, a recapture determination shall be made with respect to such shareholder. For purposes of such recapture determination the period of employment of any employee or employees with respect to whom WIN expenses were paid or incurred shall be the period beginning with the initial date of employment (as defined in paragraph (c)(1) of §1.50A–3) with respect to the electing small business corporation and ending with the date on which such reduction occurs.

(ii) The percentage referred to in subdivision (i)(*b*) of this subparagraph is 66⅔ percent of the shareholder's proportionate stock interest in the corporation on the date of the apportionment under paragraph (a) of §1.50B–2. However, once employment of an employee has been treated under this subparagraph as having terminated with respect to the shareholder to any extent, the percentage referred to shall be 33⅓ percent of the shareholder's proportionate stock interest in the corporation on the date of apportionment under paragraph (a) of §1.50B–2.

(iii) In determining a shareholder's proportionate stock interest in a former electing small business corporation for purposes of this subparagraph, the shareholder shall be considered to own stock in such corporation which he owns directly or indirectly (through ownership in other entities provided such other entities' bases in such stock are determined in whole or in part by reference to the basis of such stock in the hands of the shareholder). For example, if A, who owns all of the 100 shares of the outstanding stock of corporation X, a corporation which was formerly an electing small business corporation, transfers on November 1, 1973, 70 shares of X stock to corporation Y in exchange for 90 percent of the stock of Y in a transaction to which section 351 applies, then, for purposes of subdivision (i) of this subparagraph, A shall be considered to own 93 percent of the stock of X, 30 percent directly and 63 percent indirectly (*i.e.*, 90 percent of 70). Any taxpayer who seeks to establish his interest in the stock of a former electing small business corporation under the rule of this subdivision shall maintain adequate records to demonstrate his indirect interest in the corporation after any such transfer or transfers.

(3) *Computation of the first 12 months of employment.* The period described in paragraph (a)(1) of §1.50A–3 shall not be affected by a change in the shareholders in such corporation and shall not be affected by a reduction in any shareholder's proportionate stock interest in such corporation (for example, by a sale or redemption or by the issuance of additional shares). Thus, the first 12 months of employment (whether or not consecutive) of any WIN employee shall be the same with respect to any shareholder who is allowed a credit under section 40 for salaries and wages paid or incurred for services rendered by such employee. Also, such first 12 months of employment and the period described in section 50B(c)(4) with respect to any WIN employee shall not be deemed to begin again in the case of a corporation making a valid election under section 1372.

(b) *Election of a small business corporation under section 1372*—(1) *General rule.* If a corporation makes a valid election under section 1372 to be an electing small business corporation (as defined in section 1371(b)), then on the last day of the first taxable year immediately preceding the taxable year for which such election is effective, the employment of any WIN employees whose initial date of employment (as defined in paragraph (c)(1) of § 1.50A–3) occurred in taxable years prior to the first taxable year for which the election is effective (and whose employment has not been terminated prior to such last day) shall be considered as having been terminated on such last day with respect to the WIN expenses paid or incurred by such corporation and § 1.50A–3 shall apply to such corporation. However, if the corporation and each of the persons who are shareholders of the corporation on the first day of the first taxable year for which the election under section 1372 is to be effective, or on the date of such election, whichever is later, execute the agreement specified in subparagraph (2) of this paragraph, § 1.50A–3 shall not apply with respect to any such WIN expenses by reason of the election by the corporation under section 1372.

(2) *Agreement of shareholders and corporation.* (i) The agreement referred to in subparagraph (1) of this paragraph shall be signed by the shareholders and by the corporation. The agreement shall recite that:

(*a*) In the event the employment of any WIN employee described in subparagraph (1) of this paragraph is later terminated (in a termination subject to the rules contained in paragraph (a) of § 1.50A–3) during a taxable year of the corporation for which the election under section 1372 is effective, each signer agrees to notify the district director or the director of the Internal Revenue service center of such termination, and agrees to be jointly and severally liable to pay to the district director or the director of the Internal Revenue service center an amount equal to the increase in tax which would have been imposed by § 1.50A–3 on the corporation but for the agreement under this paragraph.

(*b*) In the event any WIN employee described in subparagraph (1) of this paragraph is paid wages (as defined in section 50B(b) and paragraph (b) of § 1.50B–1) by such electing corporation, which are less than the wages paid to other employees of such electing corporation who perform comparable services (as defined in paragraph (a)(2)(ii) of § 1.50A–3), during a taxable year of the corporation for which the election under section 1372 is effective, each signer agrees to notify the district director or the director of the Internal Revenue service center of such failure to pay equal wages for comparable services, and agrees to be jointly and severally liable to pay to the district director or the director of the Internal Revenue service center an amount equal to the increase in tax which would have been imposed by § 1.50A–3 on the corporation as a result of such failure but for the election under section 1372.

For purposes of computing the period described in paragraph (a)(1) of § 1.50A–3, the period of employment by the corporation before the election under section 1372 shall be added to the period of employment by the electing small business corporation after such election.

(ii) The agreement shall set forth the name, address, and taxpayer account number of each party and the internal revenue district or service center in which each such party files his or its income tax return for the taxable year which includes the last day of the corporation's taxable year immediately preceding the first taxable year for which the election under section 1372 is effective. The agreement may be signed on behalf of the corporation by any person who is duly authorized. The agreement shall be filed with the district director or the director of the Internal Revenue service center with whom the corporation files its income tax return for its taxable year immediately preceding the first taxable year for which the election under section 1372 is effective and shall be filed on or before the due date (including extensions of time) of such return. For purposes of the preceding sentence, the district director or the director of the Internal Revenue service center may, if good cause is shown, permit the agreement to be filed on a later date.

(c) *Examples.* This section may be illustrated by the following examples:

Example 1. (i) X Corporation, an electing small business corporation which makes its returns on the basis of the calendar year, hired employees under a WIN program on July 1, 1972, and incurred expenses for such employees during the following 12 months at an initial rate of $10,000 per month. For taxable year 1972, X Corporation had 20 shares of stock outstanding which were owned equally by A and B who make their returns on the basis of a calendar year. Under paragraph (a) of this section, the WIN expenses were apportioned to the shareholders of X Corporation as follows:

	Period ending Dec. 31, 1973
Total WIN expenses for the taxable year	$60,000
Shareholder A (10/20)	30,000
Shareholder B (10/20)	30,000

Assuming that during 1972 shareholders A and B did not directly incur any WIN expenses and that they did not own any interest in other electing small business corporations, partnerships, estates, or trusts incurring WIN expenses, the WIN expenses attributable to each shareholder is $30,000. For the taxable year 1972, each shareholder's credit earned of $6,000 (20 percent of $30,000) was allowed under section 40 as a credit against his liability for tax.

(ii) On January 1, 1973, X Corporation terminates the employment of the employees accounting for 50 percent of its WIN expenses incurred to that date, or $30,000 in salaries and wages. The actual period of employment for these WIN employees was 6 months. For taxable year 1972, each shareholder's recomputed credit is $3,000 (20 percent of $15,000). The income tax imposed by chapter 1 of the Code on each of the shareholders for the taxable year 1973 is increased by the $3,000 decrease in his credit earned for the taxable year 1972 (that is, $6,000 original credit earned minus $3,000 recomputed credit earned).

Example 2. (i) The facts are the same as in subdivision (i) of example 1, except that on January 1, 1973, shareholder A sells five of his 10 shares of stock in X Corporation to C. No other changes in stock ownership occurred during 1973. Under paragraph (a)(2) of this section, the WIN expenses of X Corporation were apportioned on December 31, 1973, to the shareholders of X Corporation as follows:

	Period ending Dec. 31, 1972
Total WIN expenses for the taxable year	$60,000
Shareholder A (5/20)	15,000
Shareholder B (10/20)	30,000
Shareholder C (5/20)	15,000

(ii) Under paragraph (a)(2) of this section, on January 1, 1973, the employment of these WIN employees shall be deemed terminated by shareholder A with respect to 50 percent of the WIN expenses allocated to him since immediately after the January 1, 1973, sale A's proportionate stock interest in X Corporation is reduced to 50 percent of the proportionate stock interest in X Corporation which he held for taxable year 1972. The actual period of employment of the WIN employees accounting for the 50 percent of the WIN expenses originally allocated to A is 6 months (that is, the period beginning with July 1, 1972, and ending with January 1, 1973). The income tax imposed by chapter 1 of the Code on shareholder A for the taxable year 1973 is increased by the $3,000 decrease in his credit earned for the taxable year 1972 (that is, $6,000 original credit earned minus $3,000 recomputed credit earned).

(d) *Termination or revocation of an election under section 1372.* The employment of employees with respect to whom WIN expenses were paid or incurred shall not be considered to have been terminated solely by reason of a termination or revocation of a corporation's election under section 1372.

[38 FR 6158, Mar. 7, 1973]

§ 1.50A–6 Estates and trusts.

(a) *In general*—(1) *Termination of employment by an estate or trust.* If an estate or trust terminates (in a termination subject to the provisions of paragraph (a) of § 1.50A–3) the employment of any employee with respect to whom WIN expenses have been paid or incurred, a recapture determination shall be made under § 1.50A–3 with respect to the estate or trust, and each beneficiary who is treated, under paragraph (a) of § 1.50B–3 as a taxpayer who paid or incurred such expenses. For purposes of each such recapture determination the period of employment of such employees shall be the period beginning with the initial date of employment (as defined in paragraph (c)(1) of § 1.50A–3) with respect to the estate or trust and ending with the date of such employee or employees' termination (as defined in paragraph (a)(1)(ii) of § 1.50A–3). For definition of ''recapture determination'' see paragraph (a)(3) of § 1.50A–3.

(2) *Disposition of interest.* (i) If—

(*a*) WIN expenses are apportioned to an estate or trust, or to a beneficiary of an estate or trust who takes such expenses into account in computing his WIN expenses, and

(*b*) After the end of the estate's, trust's, or beneficiary's taxable year in which such apportionment was taken into account and before the close of the period to which paragraph (a)(1) of §1.50A–3 applies with respect to the employees to which such WIN expenses relate, such estate's, trust's, or such beneficiary's proportionate interest in the income of the estate or trust is reduced (for example, by a sale, or by the terms of the estate or trust instrument) below the percentage specified in subdivision (ii) of this subparagraph,

then, on the date of such reduction, the employment of such employee shall be deemed terminated with respect to such estate, trust, or beneficiary to the extent of the actual reduction in such estate's, trust's, or beneficiary's proportionate interest in the income of the estate or trust. (For example, if $100 of WIN expenses were apportioned to a beneficiary and if his proportionate interest in the income of the estate or trust is reduced from 60 percent to 30 percent (that is, 50 percent of his original interest), then the employment of the employee to which such WIN expenses relates shall be deemed terminated as to that beneficiary to the extent of $50.) Accordingly, a recapture determination shall be made with respect to such estate, trust, or beneficiary. For purposes of such recapture determination the period of employment of any employee or employees with respect to whom WIN expenses were paid or incurred shall be the period beginning with the initial date of employment (as defined in paragraph (c)(1) of §1.50A–3) with respect to the estate or trust and ending with the date on which such reduction occurs.

(ii) The percentage referred to in subdivision (i)(*b*) of this subparagraph is 66⅔ percent of the estate's, trust's, or beneficiary's proportionate interest in the income of the estate or trust for the taxable year of the apportionment under paragraph (a) of §1.50B–3. However, once employment of an employee has been treated under this subparagraph as having terminated with respect to the estate, trust, or beneficiary to any extent, the percentage referred to shall be 33⅓ percent of the estate's, trust's, or beneficiary's proportionate interest in the income of the estate or trust for the taxable year of the apportionment under paragraph (a) of §1.50B–3.

(iii) In determining a beneficiary's proportionate interest in the income of an estate or trust for purposes of this subparagraph, the beneficiary shall be considered to own any interest in such an estate or trust which he owns directly or indirectly (through ownership in other entities provided such other entities' bases in such interests are determined in whole or in part by reference to the basis of such interest in the hands of the beneficiary). For example, if A, whose proportionate interest in the income of trust X is 30 percent, transfers all of such interest to corporation Y in exchange for all of the stock of Y in a transaction to which section 351 applies, then, for purposes of subdivision (i) of this subparagraph, A shall be considered to own a 30-percent interest in trust X. Any taxpayer who seeks to establish his interest in an estate or trust under the rule of this subdivision shall maintain adequate records to demonstrate his indirect interest in the estate or trust after any such transfer or transfers.

(b) *Computation of the first 12 months of employment.* The period described in paragraph (a)(1) of §1.50A–3 shall not be affected by a change in the beneficiaries of an estate or trust and shall not be affected by a reduction or a termination of a beneficiary's interest in the income of such estate or trust. Thus, the period described in paragraph (a)(1) of §1.50A–3 for any WIN employee shall be the same with respect to a trust or estate and any beneficiary of such trust or estate which is allowed a credit under section 40 for salaries and wages paid or incurred for services rendered by such employee. Also, such period with respect to any WIN employee shall not be deemed to begin again as the result of the acquisition of the interest by another.

(c) *Examples.* Paragraph (a) of this section may be illustrated by the following examples:

Example 1. (i) XYZ Trust, which makes its returns on the basis of the calendar year, hired employees under the WIN program on July 1, 1972, and incurred expenses for such employees during the following 12 months at an initial rate of $10,000 per month. For the taxable year 1972 the income of XYZ Trust is $60,000, which is allocated equally to XYZ Trust and beneficiary A. Beneficiary A makes his returns on the basis of a calendar year. Under paragraph (a) of this section, the WIN expenses were apportioned to XYZ Trust and to beneficiary A as follows:

	Period ending Dec. 31, 1972
Total WIN expenses for the taxable year	$60,000
XYZ Trust ($30,000/$60,000)	30,000
Beneficiary A ($30,000/$60,000)	30,000

Assuming that during 1972 beneficiary A did not directly incur any WIN expenses and that he did not own any interest in other estates, trusts, electing small business corporations, or partnerships incurring WIN expenses, the WIN expenses incurred by XYZ Trust and by beneficiary A are $30,000 each. For the taxable year 1972, XYZ Trust and beneficiary A each had a credit earned of $6,000. Each credit earned was allowed under section 40 as a credit against the liability for tax.

(ii) On January 1, 1973, XYZ Trust terminates the employment of its employees accounting for 50 percent of its WIN expenses incurred to that date, or $30,000 in salaries and wages. The actual period of employment for these WIN employees was 6 months. For the taxable year 1972, XYZ Trust's and beneficiary A's recomputed credit is $3,000 (20 percent of $15,000). The income tax imposed by chapter 1 of the Code on XYZ Trust and on beneficiary A for the taxable year 1973 is increased by the $3,000 decrease in his credit earned for the taxable year 1972 (that is, $6,000 original credit earned minus $3,000 recomputed credit earned).

Example 2. (i) The facts are the same as in subdivision (i) of example 1, except that on January 1, 1973, beneficiary A sells 50 percent of his interest in the income of XYZ Trust to B. No other changes in income interest occurred during 1973. Under paragraph (a)(2) of §1.50B–4, each beneficiary's share and the trust's share of the WIN expenses are apportioned as follows:

	Period ending Dec. 31, 1972
Total WIN expenses for the taxable year	$60,000
XYZ Trust ($30,000/$60,000)	30,000
Beneficiary A ($15,000/$60,000)	15,000
Beneficiary B ($15,000/$60,000)	15,000

(ii) Under paragraph (a)(2) of this section, on January 1, 1973, the employment of these WIN employees shall be deemed terminated by beneficiary A with respect to 50 percent of the WIN expenses allocated to him since immediately after the January 1, 1973, sale A's proportionate interest in the income of XYZ Trust is reduced to 50 percent of his proportionate interest in the income of XYZ Trust for the taxable year 1972. The period of employment of the WIN employees accounting for the 50 percent of the WIN expense originally allocated to A is 6 months (that is, the period beginning with July 1, 1972, and ending with December 31, 1972). For the taxable year 1972 beneficiary A's recomputed credit earned is $3,000 (20 percent of $15,000). The income tax imposed by chapter 1 of the Code on beneficiary A for the taxable year 1973 is increased by the $3,000 decrease in his credit earned for the taxable year 1972 (that is, $6,000 original credit earned minus $3,000 recomputed credit earned).

[38 FR 6159, Mar. 7, 1973]

§ 1.50A–7 Partnerships.

(a) *In general*—(1) *Termination of employment by a partnership.* If a partnership terminates (in a termination subject to the provisions of paragraph (a) of §1.50A–3) the employment of any WIN employee with respect to whom WIN expenses have been paid or incurred, a recapture determination shall be made under §1.50A–3 with respect to each partner who is treated, under paragraph (a) of §1.50B–4, as a taxpayer with respect to such expenses. Each such recapture determination shall be made with respect to the share of the WIN expenses with respect to such employee which were taken into account by such partner under paragraph (a) of §1.50B–4. For purposes of each such recapture determination the period of employment of any such employee shall be the period beginning with the initial date of employment (as defined in paragraph (c)(1) of §1.50A–3) with respect to the partnership and ending with the date of such employee's termination (as defined in paragraph (a)(1)(ii) of §1.50A–3). For the definition of ''recapture determination'' see paragraph (a)(3) of §1.50A–3.

(2) *Disposition of partner's interest.* (i) If—

(*a*) WIN expenses are allocated to a partner of a partnership who takes such expenses into account in computing his WIN expenses, and

(*b*) After the end of the partner's taxable year in which such allocation was taken into account and before the close of the period to which paragraph (a)(1) of §1.50A–3 applies with respect to the employee to which such WIN expenses relate, such partner's proportionate interest in the general profits of the partnership (or in the particular expenses) is reduced (for example, by a sale, by a change in the partnership agreement, or by the admission of a new partner) below the percentage specified in subdivision (ii) of this subparagraph,

then, on the date of such reduction the employment of such employee shall be deemed terminated with respect to such partner to the extent of the actual reduction in such partner's proportionate interest in the general profits (or in the particular expenses) of the partnership. (For example, if $100 of WIN expenses were taken into account by a partner and if his proportionate interest in the general profits of the partnership is reduced from 60 percent to 30 percent (that is, 50 percent of his original interest), then the employment of the employee to which such WIN expenses relate shall be deemed terminated as to that partner to the extent of $50.) Accordingly, a recapture determination shall be made with respect to such partner. For purposes of such recapture determination the period of employment of any employee or employees with respect to whom WIN expenses were paid or incurred shall be the period beginning with the initial date of employment (as defined in paragraph (c)(1) of §1.50A–3) with respect to the partnership and ending with the date on which such reduction occurs.

(ii) The percentage referred to in subdivision (i)(*b*) of this subparagraph is 66⅔ percent of the partner's proportionate interest in the general profits (or in the WIN expenses) of the partnership for the year of the apportionment under §1.50B–4(a). However, once employment of an employee has been treated under this subparagraph as having terminated with respect to the partner to any extent, the percentage referred to shall be 33⅓ percent of the partner's proportionate interest in the general profits (or in the WIN expenses) of the partnership for the taxable year of the apportionment under paragraph (a) of §1.50B–4.

(iii) In determining a partner's proportionate interest in the general profits (or in the WIN expenses) of a partnership for purposes of this subparagraph, the partner shall be considered to own any interest in such a partnership which he owns directly or indirectly (through ownership in other entities provided the other entities' bases in such interests are determined in whole or in part by reference to the basis of such interest in the hands of the partner). For example, if A, whose proportionate interest in the general profits of partnership X is 20 percent, transfers all of such interest to Corporation Y in exchange for all of the stock of Y in a transaction to which section 351 applies then, for purposes of subdivision (i) of this subparagraph, A shall be considered to own a 20 percent interest in partnership X. Any taxpayer who seeks to establish his interest in a partnership under the rule of this subdivision shall maintain adequate records to demonstrate his indirect interest in the partnership after any such transfer or transfers.

(3) *Computation of the first 12 months of employment.* The period described in paragraph (a)(1) of §1.50A–3 shall not be affected by a change in the partners of such partnership and shall not be affected by a change in the ratio in which the partners divide the general profits (or the WIN expenses) of the partnership. Thus, such period for any WIN employee shall be the same with respect to any partner claiming a credit under section 40 for salaries and wages paid or incurred for services rendered by such employee.

(b) *Examples.* Paragraph (a) of this section may be illustrated by the following examples:

Example 1. (i) AB partnership, which makes its returns on the basis of the calendar year, hired employees under the WIN program on July 1, 1972, and incurred expenses for such employees during the following 12 months at an initial rate of $10,000 per month. Partners A and B, who make their returns on the basis of a calendar year, share the profits and losses of AB partnership equally. Under paragraph (a)(2) of this section, each partner's share of the WIN expenses was approportioned as follows:

	Period ending Dec. 31, 1972
Total WIN expenses for the taxable year	$60,000
Partner A's share (50 percent)	30,000
Partner B's share (50 percent)	30,000

Assuming that during 1972 A and B did not directly incur any WIN expenses and that they did not own any interest in other partnerships, electing small business corporations, estates, or trusts incurring WIN expenses, each partner's share of the WIN expenses is $30,000. For the taxable year 1972, each partner's credit earned of $6,000 (20 percent of $30,000) was allowed under section 40 as a credit against his liability for tax.

(ii) On January 1, 1973, AB partnership terminates the employment of its employees accounting for 50 percent of its WIN expenses incurred to that date, or $30,000 in salaries and wages. The actual period of employment for these WIN employees was 6 months. For the taxable year 1972, each partner's recomputed credit earned is $3,000 (20 percent of $15,000). The income tax imposed by chapter 1 of the Code on each of the partners for the taxable year 1973 is increased by the $3,000 decrease in his credit earned for the taxable year 1972 (that is, $6,000 original credit earned minus $3,000 recomputed credit earned).

Example 2. (i) The facts are the same as in subdivision (i) of example 1, except that on January 1, 1973, partner A sells one-half of his 50 percent interest in AB partnership to C, to form the ABC partnership. No other changes in the partners' proportionate interest in the general profits of the partnership occurred during 1973. Under paragraph (a)(2) of this section, each partner's share of the WIN expenses was apportioned on December 31, 1973, as follows:

	Period ending Dec. 31, 1973
Total WIN expenses for the taxable year	$60,000
Partner A's share (25 percent)	15,000
Partner B's share (50 percent)	30,000
Partner C's share (25 percent)	15,000

(ii) Under paragraph (a)(2) of this section, on January 1, 1973, the employment of these WIN employees shall be deemed terminated by partner A with respect to 50 percent of the WIN expenses allocated to him since immediately after the January 1, 1973, sale, A's proportionate interest in the general profits of ABC partnership is reduced to 50 percent of his proportionate interest in the general profits of AB partnership for 1972. The period of employment of the WIN employees accounting for the 50 percent of the WIN expenses originally allocated to A is 6 months (that is, the period beginning with July 1, 1972, and ending with December 31, 1972). For the taxable year 1972 partner A's recomputed credit earned is $3,000 (20 percent of $15,000). The income tax imposed by chapter 1 of the Code on partner A for the taxable year 1973 is increased by the $3,000 decrease in his credit earned for the taxable year 1972 (that is, $6,000 original credit earned minus $3,000 recomputed credit earned).

[38 FR 6160, Mar. 7, 1973]

§ 1.50B–1 Definitions of WIN expenses and WIN employees.

(a) *WIN expenses*—(1) *In general.* Except as otherwise provided in paragraphs (b) through (g) of this section, for purposes of §§ 1.50A–1 through 1.50B–5, the term ''work incentive program expenses'' (referred to in §§ 1.50A–1 through 1.50B–5 as ''WIN expenses'') means the salaries and wages paid or incurred by the taxpayer for services rendered during the first 12 months of employment (whether or not consecutive) by an employee who is certified by the Secretary of Labor as—

(i) Having been placed in employment by the taxpayer (or if the taxpayer is a partner of a partnership, beneficiary of an estate or trust, or a shareholder of an electing small business corporation, by such partnership, estate, trust, or electing small business corporation) under a work incentive (WIN) program established under section 432(b)(1) of the Social Security Act (42 U.S.C. 632(b)(1)), and

(ii) Not having displaced any individual from employment.

The term ''WIN expenses'' includes only salaries and wages paid or incurred in taxable years beginning after December 31, 1971. See paragraph (c) of § 1.50A–3 for rules relating to the determination of the first 12 months of employment (whether or not consecutive).

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

Example 1. X Corporation, an accrual basis taxpayer which files its return on the basis of the calendar year, hired an employee on July 1, 1971, who was certified by the Secretary of Labor under this paragraph. The first 12 months of employment were continuous. X is entitled to the credit provided by section 40 with respect to the salaries or wages incurred during its taxable year beginning January 1, 1972, for services rendered by that employee during the period beginning July 1, 1971, and ending June 30, 1972.

Example 2. Y, a cash basis taxpayer who files his return on the basis of the calendar year, employed A, an employee certified by the Secretary of Labor under this paragraph, on July 1, 1971. A's first 12 months of employment were continuous. Y paid A on the basis of a semimonthly payroll period, but paid his payroll 2 days after the close of the payroll period during which the wages were earned. Thus, Y paid A on January 2, 1972, for services rendered between December 16, 1971, and December 31, 1971. Y is entitled to the credit provided by section 40 with respect to the wages paid for services rendered by A during the period beginning December 16, 1971, and ending June 30, 1972, because those wages were paid by Y in a taxable year beginning after December 31, 1971.

(b) *Salaries and wages.* For purposes of this section, the term ''salaries and wages'' means only cash remuneration including a check. Amounts deducted and withheld from the employee's pay (for example, taxes and contributions to health and retirement plans) shall be deemed to be cash remuneration even though not actually paid directly to the employee.

(c) *Trade or business expenses.* The term ''WIN expenses'' includes only salaries and wages which are paid or incurred in a trade or business of the taxpayer and which are deductible in computing taxable income. Thus, salaries and wages paid to domestic employees in a private home are not ''WIN expenses''.

(d) *Reimbursed expenses*—(1) *In general.* The term ''WIN expenses'' does not include salaries and wages to the extent that the taxpayer is reimbursed for such salaries or wages from any source.

(2) *Example.* Subparagraph (1) of this paragraph may be illustrated by the following example:

Example. X Company, which makes its return on the basis of the calendar year, hired WIN employees on January 1, 1972. X Company has a cost-plus construction contract with the Federal Government. The fact that X has a construction contract with the Federal Government or anyone else does not change its character from a normal business transaction in which there has been a sale of materials and services. Thus, the salaries or wages paid or incurred for services rendered by these WIN employees would not be reimbursed expenses, and X would be entitled to the credit provided by section 40.

(e) *Geographical limitation*—(1) *In general.* The term ''WIN expenses'' does not include salaries and wages paid or incurred for services rendered outside the United States (as defined in sections 638 (relating to Continental Shelf areas) and 7701(a)(9). However, services rendered by any WIN employee outside the United States (as defined in sections 638 (relating to Continental Shelf areas) and 7701(a)(9)) shall contribute to such employee's first 12 months of employment (whether or not consecutive) for purposes of paragraph (a) of §1.50A–3 and paragraph (a) of this section.

(2) *Example.* Subparagraph (1) of this paragraph may be illustrated by the following example:

Example. X Corporation, which files its return on the basis of the calendar year, hired A, a WIN employee, on January 1, 1972, and continuously employed him for the following 24-month period. During January and February of 1972, X paid A's wages while he received training conducted in Puerto Rico. For the remainder of the calendar year A performed services for X within the United States. For purposes of paragraph (a) of §1.50A–3 and paragraph (a) of this section, A's first 12 months of employment are January 1, 1972, to December 31, 1972. Under subparagraph (1) of this paragraph no wages paid to A for services rendered during the months of January and February of 1972 may be taken into account by X under paragraph (a) of this section as WIN expenses because the services were rendered outside the United States. However, X may take into account wages he has incurred with respect to A for the period March 1, 1972, to December 31, 1972.

(f) *Maximum period of training or instruction.* The term ''WIN expenses'' does not include salaries and wages paid or incurred for services rendered by a WIN employee after the end of the 24-month period beginning with the date of initial employment (as defined in paragraph (c)(1) of §1.50A–3) of the WIN employee.

(g) *Ineligible individuals.* The term ''WIN expenses'' does not include salaries and wages paid or incurred for services rendered by a WIN employee who—

(1) Bears any of the relationships described in paragraphs (1) through (8) of section 152(a) of the Code to the taxpayer, or, if the taxpayer is a corporation, to an individual who owns, directly or indirectly, more than 50 percent in value of the outstanding stock of the corporation (determined with the application of section 267(c) of the Code),

(2) If the taxpayer is an estate or trust, is a grantor, beneficiary, or fiduciary of the estate or trust, or is an individual who bears any of the relationships described in paragraphs (1) through (8) of section 152(a) of the Code to a grantor, beneficiary, or fiduciary of the estate or trust, or

(3) Is a dependent (described in section 152(a)(9) of the Code) of the taxpayer, or, if the taxpayer is a corporation, of an individual described in subparagraph (1), or, if the taxpayer is an estate or trust, of a grantor, beneficiary, or fiduciary of the estate or trust.

(h) *WIN employee*. For purposes of §§1.50A–1 through 1.50B–5 the term ''WIN employee'' means an employee who is certified by the Secretary of Labor as meeting the requirements of paragraphs (a)(1) (i) and (ii) of this section.

(i) [Reserved]

(j) *Special rule applicable to transactions to which section 381(a) applies and transactions involving a mere change in form of conducting a trade or business*. The first 12 months of employment (whether or not consecutive) and the period described in section 50B (c)(4) of any WIN employee, for purposes of determining the amount of WIN expenses (as defined in paragraph (a) of §1.50B–1), shall not be affected by transactions to which the rule contained in paragraph (f) (relating to transaction to which section 381(a) (relating to certain corporate acquisitions) applies), or paragraph (g) (relating to a mere change in form of conducting a trade or business) of §1.50A–4 applies.

[38 FR 6161, Mar. 7, 1973]

§ 1.50B–2 Electing small business corporations.

(a) *General rule*—(1) *In general*. In the case of an electing small business corporation (as defined in section 1371 (b)), WIN expenses (as defined in paragraph (a) of §1.50B–1) shall be apportioned pro rata among the persons who are shareholders of such corporation on the last day of such corporation's taxable year, and shall be taken into account for the taxable years of such shareholders within which or with which the taxable year of such corporation ends. The WIN expenses for each employee shall be apportioned separately. In determining who are shareholders of an electing small business corporation on the last day of its taxable year, the rules of paragraph (d)(1) of §1.1371–1 and of paragraph (a)(2) of §1.1373–1 shall apply.

(2) *Shareholder as taxpayer*. A shareholder to whom WIN expenses are apportioned shall, for purposes of the credit allowed by section 40, be treated as the taxpayer who paid or incurred the expenses allocated to him. If a shareholder takes into account in determining his WIN expenses any WIN expenses with respect to an employee of an electing small business corporation, and if the employment of such employee is terminated in a termination subject to the rules contained in paragraph (a) of §1.50A–3, or if the electing small business corporation fails to pay comparable wages and such failure is subject to the rules contained in paragraphs (a) (2) and (3) of §1.50A–3, then such shareholder shall make a recapture determination under the provisions of section 50A (c) and (d) of the Code and §1.50A–3. See §1.50A–5.

(3) *Computation of the first 12 months of employment*. The first 12 months of employment (whether or not consecutive) and the period described in section 50B(c)(4) of any WIN employee for purposes of determining the amount of WIN expenses (as defined in paragraph (a) of §1.50B–1) shall not be affected by a change in the shareholders in such corporation and shall not be affected by a reduction in any shareholder's proportionate stock interest in such corporation (for example, by a sale or redemption or by the issuance of additional shares). Thus, the first 12 months of employment (whether or not consecutive) of any WIN employee shall be the same with respect to any shareholder claiming a credit under section 40 for salaries and wages paid or incurred for services rendered by such employee. Also, such first 12 months of employment and the period described in section 50B(c)(4), with respect to any WIN employee, shall not be deemed to begin again because of the making of a valid election under section 1372.

(b) *Summary statement*. An electing small business corporation shall attach to its return a statement showing the apportionment to each shareholder of its WIN expenses with respect to each WIN employee.

(c) *Examples*. Paragraph (a) of this section may be illustrated by the following examples:

Example 1. (i) X Corporation, an electing small business corporation which files its returns on the basis of the calendar year, hired WIN employees on July 1, 1972, whose employment was continuous for the next 24 months. A, a shareholder, has a 10 percent interest in X Corporation. X Corporation incurred $24,000 in wages with respect to these WIN employees in calendar year 1972, and $48,000 in calendar year 1973. Assuming that during 1972 shareholder A did not directly incur any other WIN expenses and did not own any other interest in other electing small business corporations, partnerships, estates, or trusts that incurred WIN expenses, for taxable year 1972 shareholder A's credit earned of $480 (10 percent (A's ownership interest) multiplied by $24,000 of WIN expenses multiplied by 20 percent) was allowed under section 40 as a credit against his liability for tax.

(ii) On March 1, 1973, shareholder A sold all of his interest to B, a new shareholder. Therefore, the employment of the WIN employees is deemed terminated for purposes of paragraph (a) of §1.50A–3 with respect to shareholder A. For taxable year 1972, A's recomputed credit is zero because the termination occurred before the end of the period described in paragraph (a)(1) of §1.50A–3. The income tax imposed by chapter 1 of the Code on A for the taxable year 1973 is increased by the $480 decrease in his credit earned for the taxable year 1972 (that is, $480 original credit earned minus zero recomputed credit earned). Under paragraph (a) of this section A has no credit earned for 1973.

(iii) Under paragraph (a)(1) of this section, assuming that during 1973 shareholder B did not directly incur any other WIN expenses and that he did not own any interest in other electing small business corporations, partnerships, estates, or trusts that incurred WIN expenses, shareholder B's credit earned is $480 (10 percent (B's ownership interest) multiplied by $24,000 of WIN expenses multiplied by 20 percent) and is allowable under section 40 as a credit against his liability for tax. Under paragraph (a)(3) for purposes of determining the period of employment that may be taken into account by B the initial date of employment of these WIN employees relates back to the date they were first employed, *i.e.*, July 1, 1972. Thus, the first 12 months of employment ends on June 30, 1973.

Example 2. (i) Y Corporation, an electing small business corporation which files its return on the basis of the calendar year, hires five WIN employees in 1972. The WIN expenses incurred with respect to each employee are as follows:

WIN employee No.	WIN expenses
1	$6,000
2	5,000
3	4,000
4	4,000
5	3,000
Total	22,000

On December 31, 1972, Y Corporation has 10 shares of stock outstanding which are owned as follows: A owns 3 shares, B owns 2 shares, and C owns 5 shares.

(ii) Under this section, the WIN expenses are apportioned to the shareholders of Y Corporation as follows:

WIN employees	1	2	3	4	5	Total
Total WIN expenses	$6,000	$5,000	$4,000	$4,000	$3,000	
Shareholder A (3/10)	1,800	1,500	1,200	1,200	900	6,600
Shareholder B (2/10)	1,200	1,000	800	800	600	4,400
Shareholder C (5/10)	3,000	2,500	2,000	2,000	1,500	11,000

Assume that shareholders A, B, and C did not directly incur any other WIN expenses during their taxable year in which falls December 31, 1972 (the last day of Y Corporation's taxable year), and that such shareholders did not own any interest in other electing small business corporations, partnerships, estates or trust that incurred WIN expenses. The total WIN expenses of shareholder A are $6,600, of shareholder B are $4,400, and of shareholder C are $11,000.

[38 FR 6162, Mar. 7, 1973]

§ 1.50B–3 Estates and trusts.

(a) *General rule*—(1) *In general.* In the case of an estate or trust, WIN expenses (as defined in paragraph (a) of §1.50B–1) shall be apportioned among the estate or trust and its beneficiaries on the basis of the income of such estate or trust allocable to each. There shall be apportioned to the estate or trust for its taxable year, and to each beneficiary of such estate or trust for his taxable year in which or with which the taxable year of such estate or trust ends, his share (as determined under paragraph (b) of this section) of the total WIN expenses. The WIN expenses for each employee shall be apportioned separately.

(2) *Beneficiary as taxpayer.* A beneficiary to whom WIN expenses are apportioned shall, for purposes of the credit allowed by section 40, be treated as the taxpayer who paid or incurred such WIN expenses allocated to him. If a beneficiary takes into account in determining his WIN expenses any portion of the WIN expenses paid or incurred by an estate or trust and if the employee with respect to which the WIN expenses were paid or incurred is terminated in a termination subject to the rules in paragraph (a) of §1.50A–3, or if there is a failure (which is subject to the rules is paragraphs (a) (2) and (3) of §1.50A–3) to pay such employee comparable wages then such beneficiary shall make a recapture determination under the provisions of section 50A (c) and (d) of the Code and §1.50A–3. See §1.50A–6.

(3) *Beneficiary.* For purposes of this section, the term ''beneficiary'' includes heir, legatee, and devisee.

(4) *Special rule for termination of interest.* If during the taxable year of an estate or trust a beneficiary's interest in the income of such estate or trust terminates, WIN expenses paid or incurred by such estate or trust after such termination shall not be apportioned to such beneficiary.

(b) *Share.* A trust's, estate's, or beneficiary's share of the WIN expenses with respect to each employee shall be:

(1) The total WIN expenses incurred in the taxable year of the estate or trust with respect to such employee, multiplied by

(2) The amount of income allocable to such estate or trust or to such beneficiary for such taxable year, divided by

(3) The sum of the amounts of income allocable to such estate or trust and all its beneficiaries taken into account under subparagraph (2) of this paragraph.

(c) *Limitation based on amount of tax.* In the case of an estate or trust, the $25,000 amount specified in section 50A(a)(2), relating to limitation based on amount of tax, shall be reduced for the taxable year to—

(1) $25,000, multiplied by

(2) The WIN expenses apportioned to such estate or trust under paragraph (a) of this section, divided by

(3) The WIN expenses apportioned among such estate or trust and its beneficiaries.

(d) *Computation of the first 12 months of employment.* The first 12 months of employment (whether or not consecutive) and the period described in section 50B(c)(4) of any WIN employee for purposes of determining the amount of WIN expenses (as defined in paragraph (a) of §1.50B–1) shall not be affected by a change in the beneficiaries of an estate or trust and shall not be affected by a reduction or a termination of a beneficiary's interest in the income of such estate or trust. Thus, the first 12 months of employment (whether or not consecutive) of any WIN employee shall be the same with respect to trust or estate, and any beneficiary of such trust or estate claiming a credit under section 40 for salaries and wages paid or incurred for services rendered by such employee.

(e) *Summary statement.* An estate or trust shall attach to its return a statement showing the apportionment of WIN expenses with respect to each employee to such estate or trust and to each beneficiary.

(f) *Examples.* This section may be illustrated by the following examples:

Example 1. (1) XYZ trust, which makes its return on the basis of the calendar year, hires five WIN employees in 1972. The WIN expenses incurred with respect to each employee are as follows:

WIN employee No.	WIN expenses
1	$6,000
2	5,000
3	4,000
4	4,000
5	3,000
Total	22,000

For the taxable year 1972 the income of XYZ trust is $10,000 which is allocable as follows: $5,000 to XYZ trust, $2,000 to beneficiary A, and $3,000 to beneficiary B. Beneficiaries A and B make their returns on the basis of a calendar year.

(2) Under this section, the WIN expenses are apportioned to XYZ trust and to its beneficiaries as follows:

WIN employees	1	2	3	4	5	Total
Total WIN expenses	$6,000	$5,000	$4,000	$4,000	$3,000	
XYZ Trust: $5,000/10,000	3,000	2,500	2,000	2,000	1,500	$11,000
Beneficiary A: $2,000/10,000	1,200	1,000	800	800	600	4,400
Beneficiary B: $3,000/10,000	1,800	1,500	1,200	1,200	900	6,600

Assume that beneficiary A hired a WIN employee during his taxable year 1972 and incurred $6,000 in wages. Also, assume that beneficiary B did not hire WIN employees during his taxable year 1972 and that beneficiaries A and B did not own any interests in other trusts, estates, partnerships, or electing small business corporations that hired WIN employees. The WIN expenses of XYZ trust are $11,000, of beneficiary A are $10,400, and of beneficiary B are $6,600.

(3) In the case of XYZ trust, the $25,000 amount specified in section 50A(a)(2) is reduced to $12,500, computed as follows: (i) $25,000 multiplied by (ii) $11,000 (WIN expense apportioned to the trust), divided by (iii) $22,000 (total WIN expenses apportioned among such trust ($11,000), beneficiary A ($4,400), and beneficiary B ($6,600)).

Example 2. The facts are the same as in example 1 except that beneficiary A's interest is reduced to zero. Under paragraph (a)(2) for purposes of determining the period of employment that may be taken into account by XYZ trust and by beneficiary B, the initial date of employment of the WIN employees relates back to the date they were first employed.

[38 FR 6163, Mar. 7, 1973]

§ 1.50B–4 Partnerships.

(a) *General rule*—(1) *In general.* In the case of a partnership, each partner shall take into account separately, for his taxable year with or within which the partnership taxable year ends, his share (as determined under subparagraph (3) of this paragraph) of the WIN expenses (as defined in paragraph (a) of § 1.50B–1) of employees employed by the partnership during such partnership's taxable year. The WIN expenses for each employee shall be allocated separately.

(2) *Partner as taxpayer.* Each partner shall be treated as the taxpayer who paid or incurred the share of the WIN expenses allocated to him. If a partner takes into account in determining his WIN expenses the WIN expenses of an employee of a partnership, and if the employment of such employee is terminated in a termination subject to the rules contained in paragraph (a) of § 1.50A–3, or if the partnership fails to pay comparable wages and such failure is subject to the rules contained in paragraphs (a) (2) and (3) of § 1.50A–3, then such partner shall make a recapture determination under the provisions of section 50A (c) and (d) of the Code and § 1.50A–3. See § 1.50A–7.

(3) *Determination of partner's share.* (i) Each partner's share of the WIN expenses shall be determined in accordance with the ratio in which the partners divide the general profits of the partnership (that is, the taxable income of the partnership as described in section 702 (a)(9)) regardless of whether the partnership has a profit or a loss for the taxable year during which the WIN expenses are paid or incurred. However, if the ratio in which the partners divide the general profits of the partnership changes during the taxable year of the partnership, the ratio effective for the date on which the WIN expenses are paid or incurred shall apply.

(ii) Notwithstanding subdivision (i) of this subparagraph, if the deduction with respect to any WIN expenses is specially allocated and if such special allocation is recognized under section 704 (a) and (b) and paragraph (b) of § 1.704–1, then each partner's share of the WIN expenses shall be determined by reference to such special allocation effective for the date on which the WIN expenses are paid or incurred.

(4) *Computation of the first 12 months of employment.* The first 12 months of employment (whether or not consecutive) and the period described in section 50B(c)(4) with respect to any WIN employee for purposes of determining the amount of WIN expenses (as defined in paragraph (a) of § 1.50B–1) shall not be affected by a change in the partners of such partnership and shall not be affected by a change in the ratio in which the partners divide the general profits of the partnership. Thus, the first 12 months of employment (whether or not consecutive) and the 24-

month period described in section 50B(c)(4) of any WIN employee shall be the same with respect to any partner claiming a credit under section 40 for salaries and wages paid or incurred for services rendered by such employee.

(b) *Summary statement.* A partnership shall attach to its return a statement showing the allocation to each partner of its WIN expenses with respect to each WIN employee.

(c) *Examples.* Paragraph (a) of this section may be illustrated by the following examples:

Example 1. Partnership ABCD hires a WIN employee on January 1, 1972, and hires a second WIN employee on September 1, 1972. The ABCD partnership and each of its partners reports income on the basis of the calendar year. Partners A, B, C, and D share partnership profits equally. Each partner's share of the WIN expenses incurred with respect to these employees is 25 percent.

Example 2. Assume the same facts as in example 1 and the following additional facts: A dies on June 30, 1972, and B purchases A's interest as of such date. Each partner's share of the profits from January 1 to June 30 is 25 percent. From July 1 to December 31, B's share of the profits is 50 percent, and C and D's share of the profits is 25 percent each. B shall take into account 25 percent of the WIN expenses incurred during the period beginning January 1 and ending June 30 and 50 percent of the WIN expenses incurred during the remainder of the year with respect to the employee hired on January 1, 1972. Also, B shall take into account 50 percent of the WIN expenses incurred with respect to the employee hired on September 1, C and D shall each take into account 25 percent of the WIN expenses incurred with respect to the employees employed by the partnership in 1972. Under paragraph (a)(3), for purposes of determining the period of employment that may be taken into account by B, the initial date of employment of the WIN employee hired on January 1 relates back to the date he was first employed, *i.e.*, January 1, 1972.

Example 3. Partnership SH is engaged in manufacturing. Under the terms of the partnership agreements deductions attributable to the employment of WIN employees are specially allocated 70 percent to partner S and 30 percent to partner H. In all other respects S and H share profits and losses equally. If the special allocation with respect to the WIN expenses is recognized under section 704 (a) and (b) and paragraph (b) of §1.704–1, the WIN expenses shall be taken into account, 70 percent by S and 30 percent by H.

Example 4. (i) LMN partnership, which files its return on the basis of the calendar year, hires five WIN employees in 1973. The WIN expenses incurred with respect to each employee are as follows:

WIN employee No.	WIN expenses
1	$6,000
2	5,000
3	4,000
4	4,000
5	3,000
Total	22,000

On December 31, 1973, the ratio in which the partners divide the general profits of the LMN partnership is as follows: L receives three-tenths of the general profits, M receives two-tenths of the general profits, and N receives five-tenths of the general profits.

(ii) Under this section the WIN expenses are apportioned to the partners of LMN partnership as follows:

WIN employees	1	2	3	4	5	Total
Total WIN expenses	$6,000	$5,000	$4,000	$4,000	$3,000	$22,000
Partner L (3/10)	1,800	1,500	1,200	1,200	900	6,600
Partner M (2/10)	1,200	1,000	800	800	600	4,400
Partner N (5/10)	3,000	2,500	2,000	2,000	1,500	11,000

Assume that partners L, M, and N did not directly incur any other WIN expenses during their taxable year in which falls December 31, 1973 (the last day of LMN partnership's taxable year) and that such partners did not own any interest in other partnerships, electing small business corporations, estates, or trusts that incurred WIN expenses. The total WIN expenses of partner L are $6,600, of partner M are $4,400, and of partner N are $11,000.

[38 FR 6164, Mar. 7, 1973]

§1.50B–5 Limitations with respect to certain persons.

(a) *Mutual savings institutions.* In the case of an organization to which section 593 applies (that is, a mutual savings bank, a cooperative bank, or a domestic building and loan association)—

(1) WIN expenses shall be 50 percent of the amount otherwise determined under paragraph (a) of §1.50B–1, and

(2) The $25,000 amount specified in section 50A(a)(2), relating to limitation based on amount of tax, shall be reduced by 50 percent of such amount.

For example, a domestic building and loan association incurs $30,000 in WIN expenses (as determined under paragraph (a) of § 1.50B–1) during its taxable year. However, under this paragraph such amount is reduced to $15,000 (50 percent of $30,000). If an organization to which section 593 applies is a member of a controlled group (as defined in section 50A(a)(5)), the $25,000 amount specified in section 50A(a)(2) shall be reduced in accordance with the provisions of paragraph (f) of § 1.50A–1 before such amount is further reduced under this paragraph.

(b) *Regulated investment companies and real estate investment trusts.* (1) In the case of a regulated investment company or a real estate investment trust subject to taxation under subchapter M, chapter 1 of the Code—

(i) The WIN expenses determined under paragraph (a) of § 1.50B–1, and

(ii) The $25,000 amount specified in section 50A(a)(2), relating to limitation based on amount of tax,

shall be reduced to such person's ratable share of each such amount. If a regulated investment company or a real estate investment trust is a member of a controlled group (as defined in section 50A (a)(5)), the $25,000 amount specified in section 50A(a)(2) shall be reduced in accordance with the provisions of paragraph (f) of § 1.50A–1 before such amount is further reduced under this paragraph.

(2) A person's ratable share of the amount described in subparagraph (1)(i) and the amount described in subparagraph (1)(ii) of this paragraph shall be the ratio which—

(i) Taxable income for the taxable year, bears to,

(ii) Taxable income for the taxable year plus the amount of the deduction for dividends paid taken into account under section 852(b)(2)(D) in computing investment company taxable income, or under section 857(b)(2)(B) (section 857(b)(2)(C), as then in effect, for taxable years ending before October 5, 1976) in computing real estate investment trust taxable income, as the case may be.

For purposes of the preceding sentence, the term ''taxable income'' means, in the case of a regulated investment company, its investment company taxable income (within the meaning of section 852(b)(2)) and, in the case of a real estate investment trust its real estate investment trust, taxable income (within the meaning of section 857(b)(2)). In the case of a taxable year ending after October 4, 1976, real estate investment trust taxable income, for purposes of this paragraph, is determined by excluding any net capital gain, and by computing the deduction for dividends paid without regard to capital gains dividends (as defined in section 857(b)(3)(C)). The amount of the deduction for dividends paid includes the amount of deficiency dividends (other than capital gains deficiency dividends) taken into account in computing investment company taxable income or real estate investment trust taxable income for the taxable year. See section 860(f) for the definition of deficiency dividends.

(3) This paragraph may be illustrated by the following example:

Example. (i) Corporation X, a regulated investment company subject to taxation under section 852 of the Code, which makes its return on the basis of the calendar year, incurs WIN expenses of $30,000 during the year 1974. Corporation X's investment company taxable income under section 852 (b)(2) is $10,000 after taking into account a deduction for dividends paid of $90,000.

(ii) Under this paragraph, Corporation X's WIN expenses for the taxable year 1974 is $3,000, computed as follows: (*a*) $30,000 (WIN expenses), multiplied by (*b*) $10,000 (taxable income), divided by (*c*) $100,000 (taxable income plus the deduction for dividends paid). For 1974, the $25,000 amount specified in section 50A(a)(2) is reduced to $2,500.

(c) *Cooperatives.* (1) In the case of a cooperative organization described in section 1381(a)—

(i) The WIN expenses determined under paragraph (a) of § 1.50B–1, and

(ii) The $25,000 amount specified in section 50A(a)(2), relating to limitation based on amount of tax,

shall be reduced to such cooperative's ratable share of each such amount (as determined under subparagraph (2) of this paragraph). If a cooperative organization described in section 1381(a) is a member of a controlled group (as defined in section 50A(a)(5)), the $25,000 amount specified in section 50A(a)(2) shall be reduced in accordance with the provisions of paragraph (f) of §1.50A–1 before such amount is further reduced under this paragraph.

(2) A cooperative's ratable share of the amount described in subparagraph (1)(i) and the amount described in subparagraph (1)(ii) of this paragraph shall be the ratio which—

(i) Taxable income for the taxable year, bears to

(ii) Taxable income for the taxable year plus the sum of (*a*) the amount of the deductions allowed under section 1382(b), and (*b*) the amount of the deductions allowed under section 1382(c), and (*c*) amounts similar to the amounts described in (*a*) and (*b*) of this subdivision the tax treatment of which is determined without regard to subchapter T, chapter 1 of the Code and the regulations thereunder.

(3) This paragraph may be illustrated by the following example:

Example. (i) Cooperative X, an organization described in section 1381(a) which makes its return on the basis of the calendar year, incurs WIN expenses of $30,000 for the taxable year 1972. Cooperative X's taxable income is $10,000 after taking into account deductions of $30,000 allowed under section 1382(b), and deductions of $60,000 allowed under section 1382(c).

(ii) Under this paragraph, Cooperative X's WIN expenses for the taxable year 1972 are $3,000, computed as follows: (*a*) $30,000 (WIN expenses), multiplied by (*b*) $10,000 (taxable income), divided by (*c*) $100,000 (taxable income plus the sum of deductions allowed under sections 1382(b) and 1382(c)). For 1972, the $25,000 amount specified in section 50A(a)(2) is reduced to $2,500.

(Sec. 860(e) (92 Stat. 2849, 26 U.S.C. 860(e)); sec. 860(g) (92 Stat. 2850, 26 U.S.C. 860(g)); sec. 7805 (68A Stat. 917, 26 U.S.C. 7805))

[38 FR 6164, Mar. 7, 1973, as amended by T.D. 7767, 46 FR 11262, Feb. 6, 1981; T.D. 7936, 49 FR 2105, Jan. 18, 1984]

§ 1.51–1 Amount of credit.

(a) *Determination of amount*—(1) *General rule.* Except as provided in paragraph (a)(2) of this section, the amount of the targeted jobs credit for purposes of section 38 (formerly designated section 44B) for the taxable year equals 50 percent of the qualified first-year wages (minus any qualified first-year wages paid to individuals while such individuals are qualified summer youth employees) plus 25 percent of the qualified second-year wages.

(2) *Special rule for employment of qualified summer youth employees.* In the case of an employer who pays or incurs qualified wages after April 30, 1983, to a qualified summer youth employee beginning work for the employer after such date, the amount of the targeted jobs credit for the taxable year is equal to the amount determined under paragraph (a)(1) of this section plus an amount equal to 85 percent of the first $3,000 of qualified wages paid to each qualified summer youth employee during the taxable year. Such wages must be attributable to services tendered by the qualified summer youth employee during any 90-day period beginning on or after May 1 and ending on or before September 15.

(3) *Limitation.* See section 38(c) for rules limiting the amount of the credit to a percentage of the amount of the taxpayer's net tax liability.

(b) *Definitions*—(1) *Qualified wages.* The term ''qualified wages'' means wages (as defined in paragraph (b)(4)) paid or incurred by the employer during the taxable year to individuals who are members of a targeted group (within the meaning of section 51(d)).

(2) *Qualified first-year wages*—(i) *General rule.* Except in the case of qualified summer youth employees, the term ''qualified first-year wages'' means the first $6,000 of wages (as defined in paragraph (b)(4) of this section) attributable to service rendered by a member of a targeted group during the 1-year period beginning with the day the individual first begins work for the employer. In the case of a vocational rehabilitation referral (as defined in section 51(d)(2)) who begins work for the employer before July 19, 1984, the one-year period begins with the day the individual begins work for the employer on or after the beginning of such individual's rehabilitation plan. However, with the exception of vocational rehabilitation referrals for whom the employer claimed a credit under section 44B (as in effect prior to enactment of the Revenue Act of 1978) for a taxable year beginning before January 1, 1979,

members of a targeted group who are first hired after September 26, 1978, and before January 1, 1979, will be treated as if they first began work for the employer on January 1, 1979. The date on which the wages are paid is not determinative of whether the wages are first-year wages; rather, the wages must be attributed to the period during which the work was performed. See paragraph (f)(1) of this section for an additional limitation on the term ''qualified first-year wages''. (See examples 1, 2, 3, 4, 5, and 6 in paragraph (j) of this section for examples illustrating the application of the rules in this paragraph (b)(2)).

(ii) *Special rule for qualified summer youth employees.* In the case of a qualified summer youth employee, qualified first-year wages for purposes of the 85 percent credit referred to in paragraph (a)(2) of this section include only wages attributable to services rendered by a qualified summer youth employee during any 90-day period beginning on or after May 1 and ending on or before September 15. If the individual is retained by the employer after the 90-day period and recertified as a member of another targeted group, the term ''qualified first-year wages'' for purposes of the 50 percent credit described by section 51(a)(1) has the meaning assigned that term in paragraph (b)(2)(i) of this section except that the $6,000 limitation for qualified first-year wages shall be reduced by wages up to, but not more than, $3,000 attributable to services rendered during the 90-day period.

(3) *Qualified second-year wages.* The term ''qualified second-year wages'' means the first $6,000 of wages attributable to services rendered by a member of a targeted group, other than a qualified summer youth employee, during the 1-year period beginning on the day after the last day of the period for qualified first-year wages. The date on which the wages are paid is not determinative of whether the wages are second-year wages; rather, the wages must be attributed to the period during which the work was performed.

(4) *Wages*—(i) *General rule.* Except as otherwise provided in paragraphs (b)(4) (ii) and (iii) of this section, the term ''wages'' shall only include amounts paid or incurred after December 31, 1978, for taxable years ending after December 31, 1978. For purposes of this section, the term ''wages'' has the meaning assigned such term by section 3306(b) (determined without regard to any dollar limitation contained in such subsection).

(ii) *Special rules.* In the case of agricultural labor or railway labor, the term ''wages'' means unemployment insurance wages within the meaning of subparagraph (A) or (B) of section 51(h)(1). The term ''wages'' shall not include any amounts paid or incurred by an employer for any pay period to any individual for whom the employer receives federally funded payments for on-the-job training for such individual for such pay period. (See example 7 in paragraph (j) of this section.) The amount of wages which would otherwise be qualified wages under this section with respect to an individual for a taxable year shall be reduced by an amount equal to the amount of payments made to the employer (however utilized by such employer) with respect to such individual for such taxable year under a program established under section 414 of the Social Security Act. In addition, the term ''wages'' shall not include any amount paid or incurred by the employer in a taxable year beginning before January 1, 1982, to an individual with respect to whom the employer claims a credit under section 40 (relating to expenses of work incentive programs). For youths participating in a qualified cooperative education program:

(A) Section 3306(c)(10)(C) (relating to the definition of employment for certain students) does not apply in determining wages under this section; and

(B) The term ''wages'' shall include only those amounts paid or incurred by the employer that are attributable to services rendered by the individual while he or she meets the conditions specified in section 51(d)(8)(A). For purposes of the preceding sentence, an employee who met the requirement in section 51(d)(8)(A)(iv), dealing with economically disadvantaged status, when hired, shall be deemed to continuously meet the requirement in section 51(d)(8)(A)(iv) during the time the employee is in the cooperative education program. See also paragraph (e) of this section for rules relating to the exclusion of wages paid to certain individuals.

(iii) *Termination.* The term ''wages'' shall not include any amount paid or incurred to an individual who begins work for the employer after December 31, 1985.

(5) *Special rule for eligible work incentive employees.* In the case of an eligible work incentive employee (as defined in § 1.51–1(c)(4)), this paragraph (b) shall be applied for taxable years beginning after December 31, 1981, as if such employee had been a member of a targeted group for taxable years beginning before January 1, 1982. (See example 8 in paragraph (j) of this section.)

(c) *Members of targeted groups*—(1) *In general.* An individual is a member of a targeted group if the individual is certified as (i) a vocational rehabilitation referral, (ii) an economically disadvantaged youth, (iii) an economically disadvantaged Vietnam-era veteran, (iv) an SSI recipient, (v) a general assistance recipient, (vi) a youth participating in a cooperative education program, (vii) an economically disadvantaged ex-convict, (viii) an eligible work incentive employee, (ix) a qualified summer youth employee, or (x) an involuntarily terminated CETA employee. Except as provided below, see section 51(d) of this section for a definition of these groups. See paragraph (d) of this section for rules concerning the certification of individuals as members of one of these targeted groups.

(2) *Youths participating in a qualified cooperative education Program*—(i) *Student requirements.* For an individual to qualify as a youth participating in a qualified cooperative education program, the individual must meet each of the following conditions (A) through (D)—

(A) The youth must have attained the age of 16 but not 20. (An individual reaching 19 will be treated as a youth participating in a qualified cooperative education program only for wages paid or incurred after November 26, 1979.)

(B) The youth must not have graduated from a high school or vocational school.

(C) The youth must be enrolled in and actively pursuing a qualified cooperative education program (as defined in paragraph (c)(2)(iii) of this section).

(D) With respect to wages paid or incurred after December 31, 1981, the youth must be a member of an economically disadvantaged family when initially hired.

(ii) *Economically disadvantaged family.* See section 51(d)(11) for the rules relating to the determination of whether an individual is a member of an economically disadvantaged family.

(iii) *Qualified cooperative education program.* The term ''qualified cooperative education program'' means a program of vocational education for individuals who (through written cooperative arrangements between a qualified school and one or more employers) receive instruction (including required academic instruction) by alternation of study in school with a job in any occupational field (but only if these two experiences are planned by the school and employer so that each contributes to the student's education and employability). See section 51(d)(8)(C) for the definition of a ''qualified school.'' For purposes of this paragraph, the term ''program of vocational education'' means an organized educational program which is directly related to the preparation of individuals for employment, or for additional preparation for a career requiring other than a baccalaureate or advanced degree. An ''organized educational program'' means only instruction related to the occupation or occupations for which the students are in training or instruction necessary for students to benefit from such training. The student's employment contributes to his or her education and employability only if it is related to the occupation, or a cluster of closely related occupations, for which the student is in training in school. However, the student's employment need not be directly related to or in the same technical field as the training the student receives in school. For example, a student studying carpentry does not have to work as a carpenter for the program to constitute a ''qualified cooperative education program.'' The program will qualify if, for example, the student works at a hardware store because the student's work would familiarize the student with the materials and tools used by carpenters. The program would not qualify, however, if the student works at a restaurant and generally performs tasks in such employment not related to carpentry.

(iv) *Actively pursuing.* For purposes of this paragraph (c)(2), a youth will not be considered to be ''actively pursuing'' a school's qualified cooperative education program (within the meaning of paragraph (c)(2)(iii) of this section) during summer vacation unless that school program continues during the summer vacation. Whether the school program continues during the summer vacation will be determined by examining the written agreement between the school and the employer. Thus, if a written agreement specifically covers the summer vacation period and provides for a significant degree of involvement by school personnel to provide supervision for the students in the program during that period, the school program will be considered to continue during the summer, regardless of whether classes are held during the vacation period.

(3) *General assistance recipients.* In order for an individual to qualify as a general assistance recipient, the individual, or another member of the assistance unit (within the meaning of 45 CFR 205.40(a)(1)) that the individual is a member of, must receive assistance for a period of not less than 30 days ending within the preemployment period (as defined in section 51(d)(13)) from a qualified general assistance program. A qualified general assistance program is a program of a State or a political sudivision of a State that the Secretary (after consultation with the Secretary of Health and Human Services) has designated as providing general assistance (or similar assistance) which is based on need and consists of money payments or voucher or scrip. For purposes of the preceding sentences, a program qualifying as a general assistance program by reason of non-cash assistance (*i.e.*, voucher or scrip) shall be so treated only with respect to amounts paid or incurred after July 1, 1982, to individuals beginning work for the employer after such date. For purposes of this subparagraph, the term ''money'' means cash or an instrument convertible into cash (e.g., a check).

(4) *Eligible work incentive employees.* An eligible work incentive employee means an individual who has been certified by the designated local agency (as defined in paragraph (d)(10) of this section) as—

(i) Being eligible for financial assistance under part A of title IV of the Social Security Act and as having continuously received such financial assistance during the 90-day period which immediately precedes the date on which such individual is hired by the employer, or

(ii) Having been placed in employment under a work incentive program established under section 432(b)(1) or 445 of the Social Security Act.

The provisions of this paragraph (c)(4) are effective with respect to taxable years of the employer beginning after December 31, 1981. (See paragraph (b)(5) of this section for a special rule relating to eligible work incentive employees.)

(5) *Involuntarily terminated CETA employees*—(i) *In general.* An involuntarily terminated CETA employee is an individual who first began work for an employer after August 13, 1981, in taxable years of the employer ending after August 13, 1981, and is certified by the designated local agency (as defined in paragraph (d)(10) of this section) as having been involuntarily terminated after December 31, 1980, from employment financed in whole, or in part, under a program under part D of title II or title VI of the Comprehensive Employment and Training Act.

(ii) *Termination.* Section 51(d)(10) and this paragraph (c)(5) shall not apply to any individual who begins work for the employer after December 31, 1982.

(d) *Certification*—(1) *General rule.* Except as otherwise provided in this paragraph, an individual shall not be treated as a member of a targeted group unless, on or before the day on which such individual begins work for the employer, the employer has received, or has requested in writing, a certification that the individual is a member of a targeted group from the designated local agency (as defined in paragraph (d)(10) of this section). In addition, the employer must receive a certification before the targeted jobs credit can be claimed. However, with respect to individuals who began work for the employer on or before May 11, 1982, the certification will be timely only if requested or received before the day the individual began work for the employer. In the case of a request in writing mailed via the United States Postal Service, the request shall be deemed to be made on the date of the postmark stamped on the cover in which such request was mailed to the designated local agency provided the request is mailed in accordance with the mailing requirements in §301.7502–1(c) and delivered in accordance with the delivery requirements in §301.7502–1(d). In the case of a deadline that but for this sentence would fall on a Saturday, Sunday, or a legal holiday, the deadline for making a timely request in writing for a certification or receiving a timely certification shall be the next succeeding day which is not a Saturday, Sunday, or legal holiday. (See section 7503 for the definition of "legal holiday.") See paragraph (d)(2) of this section for transitional rules applicable to certain employees who began work for the employer before September 26, 1981. See paragraph (d)(3) of this section for special rules applicable to cooperative education students and paragraph (d)(4) of this section for special rules applicable to eligible work incentive employees.

(2) *Timeliness of certification in the case of an individual to whom a written preliminary eligibility determination has been issued.* If on or before the day on which an individual begins work for the employer, such individual has received from a designated local agency (or other agency or organization designated pursuant to a written agreement with such designated local agency) a written preliminary determination that such individual is a member of a targeted group, then such individual may be treated as a member of a targeted group if on or before the fifth day after the day such individual begins work for the employer such employer receives, or requests in writing, from the designated local agency a certification that such individual is a member of a targeted group. This paragraph (d)(2) only applies to individuals who begin work for the employer after July 18, 1984.

(3) *Transitional rules for certain employees who began work for the employer on or before September 26, 1981.* In the case of an individual, other than a cooperative education student, who began work for the employer before June 29, 1981, the employer must either receive, or request in writing, a certification before July 23, 1981. In the case of an individual, other than a cooperative education student, who began work for the employer after June 28, 1981, and on or before September 26, 1981, the employer must either receive, or request in writing, a certification before September 26, 1981.

(4) *Cooperative education students.* In the case of cooperative education students, the school administering the cooperative education program must issue the certification. Form 6199 is provided for this purpose. If the student begins work for the employer after September 26, 1981, see the general rule in §1.51–1(d)(1) for the date when this certification must be received or requested. If the student begins work for the employer on or before September 26, 1981, the employer must receive the certification or request it in writing before September 26, 1981. In order for an employer to claim a credit on wages paid or incurred to a cooperative education student after December 31, 1981, the employer must receive or request in writing a determination that the student is a member of an economically disadvantaged family. A request for economic eligibility determination for a cooperative education student must be made in writing by the employer to the participating school. If the student begins work for the employer on or before September 26, 1981, the employer must receive or request in writing such determination before September 26, 1981. However, a request in writing on or after August 13, 1981, to a participating school for certification will be deemed to include a request for an economic eligibility determination. In addition, any certification issued by a school after August 13, 1981, will be deemed to be issued in response to a request for certification which includes a request for an economic eligibility determination. The rule in the

preceding sentence does not eliminate the requirement that the employer receive a certification that includes an economic eligibility determination in order to claim a credit for wages paid or incurred after December 31, 1981. If a certification issued by a school after August 13, 1984, does not contain an economic eligibility determination and the employer wishes to claim a credit for wages paid or incurred after December 31, 1981, the employer must receive a completed certification before the date on which the credit is claimed.

(5) *Eligible work incentive employees.* In the case of eligible work incentive employees, the employer must either receive, or request in writing, a certification within the time requirements of paragraph (d) (1), (2), or (3) of this section, whichever is applicable. Before October 12, 1981 (the date the Economic Recovery Tax Act of 1981 codified the State employment security agency as the designated local agency for certifying targeted groups), a certificate may be received or requested in writing from either the designated local agency (as defined in paragraph (d)(10) of this section) or the office or agency that properly issued certifications under former section 50B(h)(1) (relating to the work incentive credit).

(6) *Certifications that are not timely.* Any certification that is not timely received or requested by the employer in accordance with the rules of this paragraph will be treated as invalid. Thus, the employer will not be allowed to claim a credit under section 51 with respect to any wages paid or incurred to an employee whose certification or request for certification is not timely. A timely request for certification does not eliminate the need for the employer to receive a certification before claiming the credit. In the case of a request for certification that was denied, resubmitted, and then approved, the timeliness of the request shall be determined by the timeliness of the first request.

(7) *Incorrect certification*—(i) *In general.* Except as otherwise provided in paragraph (d)(7)(ii) of this section, if an individual has been certified as a member of a targeted group, and such certification is based on false information provided by such individual, the certification shall be revoked and wages paid by the employer after the date on which notice of revocation is received by the employer shall not be treated as qualified wages. For purposes of this paragraph, a certification will be revoked only if the individual would not have been certified had correct information been provided to the issuer of the certification. Thus, false information that is not material to an individual's eligibility as a member of a targeted group will not invalidate an otherwise valid certification.

(ii) *Employer's knowledge that the certification was incorrect.* In the case of an employer who knew, or had reason to know, at the time of certification that the information provided to the designated local agency was false, none of the wages paid by such employer to an individual to whom an incorrect certification has been issued will be qualified wages.

(8) *Certifications issued to certain rehires.* This paragraph (d)(8) applies in the case of an employee who first began work for the employer before August 13, 1981, and was dismissed and rehired by the employer. A certification received or requested by an employer with respect to such an employee will be considered timely only if there was a valid business reason, unrelated to the availability of the credit, for the dismissal and rehire and if the employer did not dismiss and then rehire the employee in order to meet the timing requirement with respect to certification. An individual who is dismissed and then rehired for the purpose described in the preceding sentence will be considered for purposes of section 51(d)(16) and this paragraph to have been continuously employed by the employer during the time between the dismissal and the rehire. Whether the employer was motivated by reason of the certification rules in section 51(d)(16) and this paragraph to dismiss and then rehire an employee is a question of fact to be determined from all the circumstances surrounding the dismissal and rehire. (See paragraph (e)(2) of this section for a separate rule disallowing the credit in the case of nonqualifying rehires.)

(9) *Individuals who continue to be employed by the same employer but as a*

member of another targeted group. This paragraph (d)(9) applies in the case of an employee who continues to be employed by the same employer but no longer qualifies as a member of the targeted group for which such employee was first certified (e.g., the employee was orginally certified as a qualified summer youth employee with respect to a ninety-day period between May 1 and September 15, but such ninety-day period has ended). In such case, the employer may request a certification that the employee is a member of another targeted group, and if any wages paid to such individual are qualified first-year wages or qualified second-year wages, the employer may be entitled to a targeted jobs credit with respect to such wages. The second certification will not be invalid merely because it was requested or received after the individual began work for the employer; only the first certification (for example, the certification with respect to an individual hired first as a qualified summer youth employee) must meet the requirement of section 51(d)(16) that a certification must be requested or received by an employer on or before the day on which the individual begins work for the employer. In the case of a former qualified summer youth employee or a youth participating in a qualified cooperative education program who is recertified as an economically disadvantaged youth, the term ''hiring date'' in section 51(d)(3)(B) does not mean the day the individual is hired by the employer but means the day the individual is certified as a member of the new targeted group. Accordingly, the age requirement of section 51(d)(3)(B) shall be applied as of the day the individual is certified as a member of the second targeted group. In addition, see section 51(d)(11) for rules concerning the viability of the original economic eligibility determination.

(10) *Certification where a trade or business has been transferred to a new employer.* In the case of a transfer of a trade or business in which an individual who is a member of a targeted group is retained as an employee in the trade or business, the certification obtained for such employee by the transferor-employer will apply with respect to the transferee-employer.

(11) *Designated local agency*—(i) *In general.* For the period before October 12, 1981, the term ''designated local agency'' means the agency for any locality designated jointly by the Secretary and the Secretary of Labor to perform certifications of employees for employers in that locality. On or after October 12, 1981, the term ''designated local agency'' means a State employment security agency established in accordance with the Act of June 6, 1933, as amended (29 U.S.C. 49 through 49n).

(ii) *Jurisdiction.* The designated local agency is the agency that has, pursuant to its charter, jurisdiction over the individual that is sought to be certified. Thus, any certification that is issued with respect to an individual who is not within the jurisdiction of the designated local agency that issued the certification will be invalid. Notwithstanding any other provision of this section, a request in writing for certification to the appropriate designated local agency that is made before January 23, 1984, will be considered to be timely if it is made after an otherwise timely request in writing for certification was made to a designated local agency that does not have jurisdiction over the individual sought to be certified.

(e) *Certain ineligible individuals*—(1) *Related individuals.* For purposes of section 51(a), ''qualified wages'' does not include any amounts paid or incurred by a taxpayer to any of the following individuals:

(i) An individual who is related (within the meaning of any of paragraphs (1) through (8) of section 152 (a)) to the taxpayer;

(ii) An individual who is a dependent (within the meaning of section 152(a)(9)) of the taxpayer;

(iii) An individual who is related (within the meaning of any of paragraphs (1) through (8) of section 152(a)) to a shareholder who owns (within the meaning of section 267(c)) more than 50 percent in value of the outstanding stock of the taypayer, if the taxpayer is a corporation;

(iv) An individual who is a dependent (within the meaning of section

152(a)(9)) of a shareholder described in paragraph (e)(1)(iii) of this section;

(v) An individual who is a grantor, beneficiary or fiduciary of the taxpayer, if the taxpayer is an estate or trust;

(vi) An individual who is a dependent (within the meaning of section 152(a)(9)) of an individual described in paragraph (e)(1)(v) of this section; or

(vii) An individual who is related (within the meaning of any of paragraphs (1) through (8) of section 152(a)) to an individual described in paragraph (e)(1)(v) of this section.

(2) *Nonqualifying rehires.* For purposes of section 51(a), ''qualified wages'' does not include wages paid to an employee who had been employed by the employer prior to the current hiring date of the employee if at any time during such prior employment the employee was not a member of a targeted group. The preceding sentence shall not apply to an employee who was previously timely certified as a member of a targeted group with respect to the same employer. An employee shall be treated as not having been a member of a targeted group if the certification requirements of section 51(d)(16) were not met. (See example 8 in paragraph (j) of this section.)

(3) *Effective date.* The provisions of this paragraph (e) are effective with respect to employees first beginning work for an employer after August 13, 1981.

(f) *Limitations*—(1) *Limitation on qualified first-year wages.* With respect to taxable years beginning before January 1, 1982, the amount of the qualified first-year wages which may be taken into account for purposes of the targeted jobs credit for any taxable year shall not exceed 30 percent of the aggregate unemployment insurance wages paid by the employer during the calendar year ending in such taxable year. In the case of a group of trades or businesses under common control (as defined in §1.52–1(b)), the qualified first-year wages cannot exceed 30 percent of the aggregate unemployment insurance wages paid to all employees of that group of trades or businesses under common control during the calendar year ending in such taxable year. For this purpose, the term ''unemployment insurance wages'' has the same meaning given to the term ''wages'' as defined in §1.51–1(b)(4). In this case of agricultural or railway labor, see section 51(h)(1) for the applicable definition of unemployment insurance wages. (See examples 13 and 14 in paragraph (j) of this section.)

(2) *Remuneration must be for trade or business employment.* Remuneration paid by an employer to an employee during any taxable year shall be taken into account only if more than one-half of the remuneration paid by the employer to an employee is for services in a trade or business of the employer. This determination shall be made by each employer without regard to section 52 (a) or (b). Accordingly, employees of corporations that are members of a controlled group or employees of partnerships, proprietorships, and other trades or businesses (whether or not incorporated) which are under common control will be treated as being employed by each separate employer for this purpose. For this purpose, the term ''year'' means the taxable year of the employer. (See example 15 in paragraph (j) of this section.)

(g) *Election not to claim the targeted jobs credit.* The election under section 51(j) (as amended by section 474(p) of the Tax Reform Act of 1984) not to claim the targeted jobs credit is available for taxable years beginning after December 31, 1983, and shall be made for the taxable year in which such credit is available by not claiming such credit on an original return or amended return at any time before the expiration of the 3-year period beginning on the last date prescribed by law for filing the return for the taxable year (determined without regard to extensions). The election may be revoked within the 3-year period by filing an amended return on which the credit is claimed.

(h) *Treatment of successor-employers.* In the case of a successor-employer referred to in section 3306(b)(1), the determination of the amount of credit under this section with respect to wages paid by such successor-employer shall be made in the same manner as if such wages were paid by the predecessor-employer referred to in such section. Thus, the 1-year period referred to in

§ 1.51–1(b)(2)(i) will be considered to begin with the day the employee first began work for the transferor-employer, and the amount of qualified first-year wages and qualified second-year wages paid or incurred with respect to the employee must be reduced by the amount of any such wages paid or incurred by the transferor-employer. (See examples 10 and 11 in paragraph (j) of this section.) Also, see paragraph (d)(10) of this section for rules concerning the viability of the employee's certification.

(i) *Treatment of employees performing services for other persons.* No credit shall be determined under this section with respect to remuneration paid by an employer to an employee for services performed by such employee for another person unless the amount reasonably expected to be received by the employer for such services from such other person exceeds the remuneration paid by the employer to such employee for such services.

(j) *Examples.* The application of this section may be illustrated by the following examples which, except as otherwise stated, assume that the limitations imposed by §§ 1.51–1(f)(2) and 1.53–3 are inapplicable:

Example 1. Corporation M is a calendar year, cash receipts and disbursements method taxpayer. A, an economically disadvantaged youth, first began work for Corporation M on October 1, 1978. Qualified first-year wages with respect to A are wages attributable to the period beginning on January 1, 1979 (since A was first hired after September 26, 1978, he is treated as having begun work on January 1, 1979) and ending on December 31, 1979. In the 1979 taxable year, Corporation M pays A $5,000 of qualified first-year wages attributable to services performed in 1979. Corporation M's allowable credit is equal to $2,500 (50 percent of $5,000).

Example 2. Assume the same facts as in example 1, except that in 1980 Corporation M pays to A $100 of wages attributable to services rendered in 1979. These wages will still be considered as qualified first-year wages, but the credit may not be claimed until the 1980 taxable year.

Example 3. Corporation O is a calendar year, cash receipts and disbursements method taxpayer. C, a vocational rehabilitation referral, first began work for Corporation O on July 1, 1978. Corporation O claimed a credit under section 44B (as in effect prior to enactment of the Revenue Act of 1978) for $3,000 of wages paid to C in the 1978 taxable year. Corporation O paid C $6,000 for services performed from January 1, 1979 to June 30, 1979. The period during which qualified first-year wages are determined begins on July 1, 1978, and ends on June 30, 1979. Amounts paid before January 1, 1979, however, are not taken into consideration in determining the amount of qualified first-year wages. Accordingly, only the wages attributable to services performed from January 1, 1979, through June 30, 1979, are considered as qualified first-year wages. Corporation O's allowable credit is equal to $3,000 (50 percent of $6,000).

Example 4. I first began work for Corporation Q, a cash receipts and disbursements method taxpayer, on January 1, 1981, and was not a member of a targeted group. On March 1, 1981, I was convicted of a felony and sentenced to prison. I quit working for Corporation Q, and served the prison sentence. On November 1, 1981, I again was hired by Corporation Q and began work on that date. On the November 1, 1981 hiring date, I was an economically disadvantaged ex-convict for whom Corporation Q received a certificate. Corporation Q paid I $500 of wages for services performed from November 1, 1981, to December 31, 1981, and $6,000 of wages for services performed during 1982. The $500 of wages paid for services performed from November 1, 1981, to December 31, 1981, would be qualified first-year wages because these qualified wages were paid for services performed during the 1-year period beginning on the date I first began work for Corporation Q (January 1, 1981). The $6,000 of wages paid for services performed during 1982 would be qualified second-year wages because these qualified wages were paid for services performed during the 1-year period beginning on the day after the first 1-year period. Accordingly, Corporation Q has an allowable credit of $250 attributable to qualified first-year wages and $1,500 attributable to qualified second-year wages.

Example 5. Assume the same facts as in example 4, except that all dates are 1 year later. Thus, I first began work for Corporation Q on January 1, 1982, was convicted on March 1, 1982, and was rehired on November 1, 1982. Under these facts, Q is not entitled to take a targeted jobs credit with respect to I's wages because I is a nonqualifying rehire.

Example 6. J, an economically disadvantaged youth, first began work for Corporation R, a calendar year cash receipts and disbursements method taxpayer, on December 1, 1979. On July 1, 1980, J was laid off by Corporation R and began work for Corporation S, which is unrelated to Corporation R, on July 2, 1980. On November 1, 1980, J again began work for Corporation R and continued working for Corporation R until January 1, 1982. At the time J first began work for Corporation S, J no longer met the qualifications of an economically disadvantaged youth. Corporation S may not claim a credit for wages paid to J because J was not a member of a targeted group at the time he began work for Corporation S. Corporation R, however, may claim a credit for wages paid to J because J was a member of a targeted group when he was hired by Corporation R. Corporation R's qualified first-year wages paid to J are the wages paid for services performed by J from December 1, 1979, to July 1, 1980, and from November 1, 1980, to November 30, 1980. Corporation R's qualified second-year wages paid to J are wages paid for services performed by J from December 1, 1980, to November 30, 1981. Corporation R may not claim a credit for wages paid for services performed by J after November 30, 1981.

Example 7. K, a member of a targeted group, first began work for Corporation T on January 1, 1979. For the pay periods from January 1, 1979, to March 31, 1979, Corporation T received federally funded payments for on-the-job training for K and paid wages of $2,000 to K. During the remainder of 1979 Corporation T paid wages of $7,000 to K. Corporation T may claim a credit on $6,000 of qualified first-year wages. Amounts paid to K by Corporation T during the pay periods for which Corporation T received federally funded payments for on-the-job training for K are not considered wages for purposes of the credit. However, Corporation T may consider $6,000 of the total $7,000 of wages paid after March 31, 1979, as qualified first-year wages.

Example 8. P first began work for Corporation X on January 1, 1981, as an individual who was certified to be an eligible employee for purposes of the WIN credit provided in section 40. Corporation X paid P $6,000 of wages during its taxable year beginning on January 1, 1981, and $6,000 of wages during its taxable year beginning on January 1, 1982. X can claim a targeted jobs credit for the wages paid in 1982 if the requirements of section 51 are met. For purposes of section 51 (a), P's qualified first-year wages are the wages paid from January 1, 1981, to December 31, 1981, and P's qualified second-year wages are the wages paid from January 1, 1982, to December 31, 1982. Thus, Corporation X is only entitled to claim a targeted job credit based on P's qualified second-year wages.

Example 9. (i) L, 15 years of age, first began work for Corporation U on August 1, 1979. On September 3, 1979, L began her junior year in high school and enrolled in a qualified cooperative education program that was to run for her junior and senior years. On October 1, 1979, when L turned 16, she met all the requirements of § 1.51–1(c)(2)(i) and qualified as a youth participating in a qualified cooperative education program. Corporation U is entitled to claim a credit on wages paid or incurred for services performed by L after September 30, 1979, so long as L meets the requisite requirements. L's summer vacation began on June 1, 1980. Assume that the cooperative education program L was enrolled in did not continue during the summer vacation (*i.e.*, the written agreement between the employer and the school did not cover the summer vacation). Thus, during her summer vacation, L did not meet the requirement of actively pursuing a qualified cooperative education program. Accordingly, Corporation U may not claim a credit on wages paid for services performed by L during L's summer vacation. On September 2, 1980, L began her senior year, and again met all the requirements of § 1.51–1(c)(2)(i). She continued to meet these requirements until June 5, 1981, when she graduated from high school. Accordingly, Corporation U may claim a credit on wages paid for services performed after September 1, 1980, and before June 5, 1981.

(ii) Assume the same facts as in (i), above, except that all dates are 3 years later. Under these facts, U is not entitled to claim a targeted jobs credit with respect to any of L's wages because L has not been timely certified under section 51(d)(16) and § 1.51–1(d)(3).

Example 10. D began work for a drugstore owned by E as a sole proprietor on January 1, 1979, and was certified as a member of a targeted group with respect to E. On June 1, 1979, E sold the drugstore where D worked to F, who continued to operate the drugstore with D as an employee. D's qualification as a member of a targeted group is not required to be redetermined in order for F to qualify for the targeted jobs credit. F will take into account the certification of D's eligibility that was provided to E. F will have qualified first-year wages consisting of the first $6,000 of wages paid or incurred to D by E and F from January 1, 1979 to December 31, 1979 (reduced by any qualified wages paid or incurred by E to D from January 1, 1979, to May 31, 1979). F's qualified second-year wages will consist of the first $6,000 of wages paid or incurred to D by F from January 1, 1980, to December 31, 1980.

Example 11. G began work in a machine shop owned by H as a sole proprietor on January 1, 1979, and was certified as a member of a targeted group with respect to H. On June 1, 1980, H transferred all the assets of the machine shop to newly formed Corporation P. Corporation P retained G as an employee in the machine shop. G's qualification as a member of a targeted group is not required to be redetermined in order for P to qualify for the targeted jobs credit. H has qualified first-year wages in the amount of the first $6,000 of wages paid or incurred to G by H from January 1, 1979, to December 31, 1979. Corporation P has qualified second-year wages in the amount of the first $6,000 of wages paid or incurred to G by H and Corporation P from January 1, 1980, to December 31, 1980 (reduced by any qualified second-year wages paid by H to G).

Example 12. W operates a retail store as a sole proprietor. On June 1, 1982, W hires S after receiving a written determination from a local community organization that S meets the requirements of an economically disadvantaged youth. W does not request a certification from the State employment security agency as to S's eligibility. W is not entitled to claim a credit with respect to wages paid to S because W did not receive, or request in writing, a certification from the State employment security agency as to S's eligibility on or before the day on which S began work for W.

Example 13. Corporation V is a cash receipts and disbursements method taxpayer with a July 1 through June 30 taxable year. In the taxable year ending June 30, 1980, the aggregate unemployment insurance wages paid by V were $150,000. In calendar year 1979 the aggregate unemployment insurance wages paid by Corporation V were $110,000. Corporation V's qualified first-year wages are limited to 30 percent of the aggregate unemployment insurance wages paid by it in calendar year 1979 or $33,000 (30 percent of $110,000), even though the aggregate unemployment insurance wages paid by it in the taxable year ending June 30, 1980, were $150,000.

Example 14. Assume the same facts as in example 13, except that all dates are 3 years later. Since the limitation on qualified first-year wages does not apply to taxable years beginning after December 31, 1981, Corporation V's qualified first-year wages are $150,000.

Example 15. M operates a retail store as a sole proprietor. N and O, both members of a targeted group, first began work for M on January 1, 1979. M paid N total qualified first-year wages of $6,000 in 1979. Three thousand one hundred dollars of those wages were for services in M's retail store, and $2,900 of those wages were for services as M's maid. M paid O total qualified first-year wages of $6,000 in 1979. Three thousand dollars of those wages were for services in M's store and $3,000 of those wages were for services as M's chauffeur. M has an allowable credit of $3,000 in 1979 on all $6,000 of qualified first-year wages paid to N because more than one-half of the remuneration paid by M to N was for services in M's trade or business. M may not take into account the wages paid to O because not more than one-half of the remuneration paid by M to O was for services in M's trade or business. Acordingly, M may not claim a credit on wages paid to O.

[T.D. 8062, 50 FR 45998, Nov. 6, 1985]

TAX SURCHARGE

§ 1.52–1 Trades or businesses that are under common control.

(a) *Apportionment of jobs credit among members of a group of trades or businesses that are under common control*—(1) *Targeted jobs credit.* (i) In the case of a group of trades or businesses that are under common control (within the meaning of paragraph (b) of this section) at any time during the calendar year, the amount of the targeted jobs credit (computed under section 51 as if all the organizations that are under common control are one trade or business) under section 4–1B must be apportioned among the members of the group on the basis of each member's proportionate share of the wages giving rise to such credit. If the group of trades or businesses that are under common control have different taxable years, the credit shall be computed as if all the organizations have the same taxable year as the organization for which a determination of the proportionate share of the credit is being made. For taxable years beginning before January 1, 1982, the amount of the qualified first-year wages cannot exceed 30 percent of the aggregate unemployment insurance wages paid by the group of trades or businesses under common control during the calendar year ending in the taxable year of the organization for which a determination of the proportionate share of the credit is being made. The limitations in section 53 and the regulations thereunder apply to each organization individually (although, in applying these limitations, an affiliated group of corporations electing to make a consolidated return shall be treated as one organization).

(ii) The application of the subparagraph may be illustrated by the following examples:

Example 1. (a) Corporation M and its three subsidiaries, Corporations N, O, and P, are a group of businesses that are under common control and each uses the cash receipts and disbursements method of accounting and has a calendar year taxable year. Corporations M, N, O, and P paid out the following amounts in unemployment insurance wages, qualified first-year wages and qualified second-year wages during 1980.

	Unemployment insurance wages	Qualified 1st-Year wages	Qualified 2d-year wages
Corporation:			
M	$600,000	$184,000	$75,000
N	300,000	85,000	90,000
O	360,000	120,000	115,000
P	24,000	24,000	0
Total	1,284,000	413,000	280,000

(b) Since Corporations M, N, O, and P are under common control, the amount of qualified first-year wages paid by the group is limited to 30 percent of the aggregate unemployment insurance wages paid by the group in the calendar year ending in the group's taxable year. Since the qualified first-year wages of $413,000 exceeds 30% of the aggregate unemployment insurance wages, the group is limited to qualified first-year wages of $385,200 (30% of $1,284,000). The amount of the targeted jobs credit attributable to qualified first-year wages is equal to $192,600 (50% of $385,200). The amount of the credit attributable to qualified second-year wages is equal to $70,000 (25% of $280,000).

(c) The credit is apportioned among Corporations M, N, O, and P on the basis of their proportionate share of the qualified first-year wages or qualified second-year wages giving rise to the credit. Each corporation's share of the credit attributable to qualified first-year wages would be computed as follows:

Corporation: Amount of credit

$$\text{M} \ldots \$192{,}600 \times \frac{\$184{,}000}{\$413{,}000} = \$85{,}807.26$$

$$\text{N} \ldots \$192{,}600 \times \frac{\$85{,}000}{\$413{,}000} = \$39{,}639.23$$

$$\text{O} \ldots \$192{,}600 \times \frac{\$120{,}000}{\$413{,}000} = \$55{,}961.26$$

$$\text{P} \ldots \$192{,}600 \times \frac{\$24{,}000}{\$413{,}000} = \$11{,}192.25$$

Each corporation's share of the credit attributable to qualified second-year wages is computed as follows:

Corporation: Amount of credit

$$\text{M} \ldots \$70{,}000 \times \frac{\$75{,}000}{\$280{,}000} = \$18{,}750$$

$$\text{N} \ldots \$70{,}000 \times \frac{\$90{,}000}{\$280{,}000} = \$22{,}500$$

$$\text{O} \ldots \$70{,}000 \times \frac{\$115{,}000}{\$280{,}000} = \$28{,}750$$

$$\text{P} \ldots \$70{,}000 \times \frac{0}{\$280{,}000} = \quad 0$$

Example 2. Assume the facts in example 1 with these additional facts. A, a member of a targeted group, worked for more than one of the members of the controlled group in the taxable year. A first began work for Corporation M on January 1, 1980, and later worked for Corporations N and O during 1980. For services rendered by A during 1980, the following wages were paid to A: Corporation M paid A $2,500 of qualified first-year wages: Corporation N paid A $1,500 of qualified first-year wages; Corporation O paid A $3,000 of qualified first-year wages. Corporations M, N, and O paid A a total of $7,000 of wages during 1980. Only $6,000 of qualified first-year wages per year per employee may be taken into account for purposes of the credit. See §1.51–1(d)(1). Since Corporations M, N, and O are treated as a single employer under section 52(a), the maximum $6,000 of qualified first-year wages paid A by the group must be apportioned among Corporations M, N, and O as follows:

Corporation: Qualified 1st year wages

$$\text{M} \ldots \$6{,}000 \times \frac{\$2{,}500}{\$7{,}000} = \$2{,}142.86$$

$$\text{N} \ldots \$6{,}000 \times \frac{\$1{,}500}{\$7{,}000} = \$1{,}285.71$$

$$\text{O} \ldots \$6{,}000 \times \frac{\$3{,}000}{\$7{,}000} = \$2{,}571.43$$

Example 3. (a) Corporation Q and its two subsidiaries, Corporations R and S, are a group of businesses that are under common control and each uses the cash receipts and disbursements method of accounting. Corporation Q has a calendar year taxable year. Corporation R has a July 1 through June 30 taxable year. Corporation S has an October 1 through September 30 taxable year. For purposes of determining Corporation R's proportionate share of the credit, the credit is computed as if Corporations Q and S have the same taxable year as Corporation R. Accordingly, Corporation R would compute its share of the credit for its 1979–1980 taxable year as set forth below.

	Unemployment insurance wages, 1979	Qualified wages paid from July 1, 1979, to June 30, 1980	
		1st year wages	2d year wages
Corporation:			
Q	$500,000	$150,000	$80,000
R	300,000	110,000	50,000
S	100,000	25,000	10,000
Total	900,000	285,000	140,000

(b) Since Corporations Q, R, and S are under common control, the amount of qualified first-year wages is limited to 30 percent of the aggregate unemployment insurance wages paid by the group during the calendar year ending in Corporation R's taxable year. Since the qualified first-year wages of $285,000 exceeds 30 percent of the aggregate unemployment insurance wages, the group is limited to qualified first-year wages of $270,000 (30% of $900,000). The amount of the targeted jobs credit attributable to qualified first-year wages paid by members of the group during the period of the taxpayer's taxable year is $135,000 (50% of $270,000). The amount of the credit attributable to qualified second-year wages paid or incurred by members of the group during the period of the taxpayer's taxable year is $35,000 (25% of $140,000).

(c) The credit is apportioned to Corporation R on the basis of its proportionate share of the qualified first-year wages and qualified second-year wages giving rise to the credit. Corporation R's share of the credit attributable to qualified first-year wages is $52,105.26

$$\$135{,}000 \times \frac{\$110{,}000}{\$285{,}000}$$

Corporation R's share of the credit attributable to qualified second-year wages is $12,500

$$\$35{,}000 \times \frac{\$50{,}000}{\$140{,}000}$$

Corporation R's share of the credit for its 1979–1980 taxable year is $64,605.26 ($52,105.26 + $12,500).

(2) *New jobs credit*. In the case of a group of trades or businesses that are under common control at any time during the calendar year, the amount of the new jobs credit (computed under section 51 as if all the organizations that are under common control are one trade or business) under section 44B (as in effect prior to enactment of the Revenue Act of 1978) must be apportioned among the members of the group on the basis of each member's proportionate contribution to the increase in unemployment insurance wages for the entire group. The limitations in section 53 (as in effect prior to enactment of the Revenue Act of 1978) and the regulations thereunder apply to each organization individually (although, in applying these limitations, an affiliated group of corporations electing to make a consolidated return shall be treated as one organization). The application of this subparagraph may be illustrated by the following example:

Example. (a) Corporation T and its three subsidiaries, U, V, and W, are a group of businesses that are under common control and each has a calendar year taxable year. Corporations T, U, V, and W have paid out the following amounts in unemployment insurance wages during 1976 and 1977:

	1976	1977	Increase in FUTA wages in 1977 over 1976
Corporation.			
T	$1,000,000	$1,015,000	+ $15,000
U	500,000	650,000	+ 150,000
V	600,000	580,000	− 20,000
W	40,000	100,000	+ 60,000
Total	2,140,000	2,345,000	205,000

(b) Since all employees of trades or, businesses that are under common control are treated as employed by a single employer, the computations in section 51 are performed as if all the organizations which are under common control are one trade or business. Consequently, the amounts of the total unemployment insurance wages of the group in 1976 (*i.e.*, $2,140,000) and 1977 (*i.e.*, $2,345,000) are used to determine the increase in unemployment insurance wages in 1977 over the 1976 wage base. Since the amount equal to 102 percent of the 1976 unemployment insurance wages ($2,182,800) is greater than the amount equal to 50 percent of the 1977 unemployment insurance wages ($1,172,500), the increase in unemployment insurance wages in 1977 over the 1976 wage base is $162,200 ($2,345,000–$2,182,800). The limitations in section 51(c), (d), and (g) (as in effect prior to enactment of the Revenue Act of 1978) must also be computed as though all the organizations under common control are one trade or business. For purposes of this example, it is assumed that none of those limitations reduce the amount of increase in unemployment insurance wages. As a result, the amount of the new jobs credit allowed to the group of business is $81,100 (50% of $162,200).

(c) The credit is apportioned among Corporations T, U, and W on the basis of their proportionate contributions to the increase in unemployment insurance wages. No credit would be allowed to Corporation V because it did not contribute to the increase in the group's unemployment insurance wages. Corporation T's share of the credit would be $5,406.66 ($81,100 × ($15,000 ÷ $225,000 (*i.e.*, $15,000 + $150,000 + $60,000))), Corporation U's share would be $54,066.67 ($81,100 × ($150,000 ÷ 225,000)), and Corporation W's share would be $21,626.67 ($81,100 × ($60,000 ÷ $225,000)).

(b) *Trades or businesses that are under common control.* For purposes of this section, the term ''trades or businesses that are under common control'' means any group of trades or businesses that is either a ''parent-subsidiary group under common control'' as defined in paragraph (c) of this section, a ''brother-sister group under common control'' as defined in paragraph (d) of this section, or a ''combined group under common control'' as defined in paragraph (e) of this section. For purposes of this section and §§ 1.52–2 and 1.52–3, the term ''organization'' means a sole proprietorship, a partnership, a trust, an estate, or a corporation. An organization may be a member of only one group of trades or businesses under common control. If, without the application of this paragraph, an organization would be a member of more than one such group, that organization shall indicate in its timely filed return the group in which it is being included. If the organization does not so indicate, then the district director with audit jurisdiction of the organization's return will determine the group in which the organization is to be included.

(c) *Parent-subsidiary group under common control*—(1) *In general.* The term ''parent-subsidiary group under common control'' means one or more chains of organizations conducting trades or businesses that are connected through ownership of a controlling interest with a common parent organization if—

(i) A controlling interest in each of the organizations, except the common parent organization, is owned (directly and with the application of § 1.414(c)–4(b)(1), relating to options) by one or more of the other organizations; and

(ii) The common parent organization owns (directly and with the application of § 1.414(c)–4(b)(1), relating to options) a controlling interest in at least one of the other organizations, excluding, in computing the controlling interest, any direct ownership interest by the other organizations.

(2) *Controlling interest defined.* For purposes of this paragraph, the term ''controlling interest'' means:

(i) In the case of a corporation, ownership of stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of the shares of all classes of stock of the corporation;

(ii) In the case of a trust or estate, ownership of an actuarial interest (determined under paragraph (f) of this section) of more than 50 percent of the trust or estate;

(iii) In the case of a partnership, ownership of more than 50 percent of the profit interest or capital interest of the partnership; and

(iv) In the case of a sole proprietorship, ownership of the sole proprietorship.

(d) *Brother-sister group under common control*—(1) *In general.* The term ''brother-sister group under common control'' means two or more organizations conducting trades or businesses if—

(i) The same five or fewer persons who are individuals, estates, or trusts own (directly and with the application of § 1.414(c)–4(b)(1)), a controlling interest of each organization; and

(ii) Taking into account the ownership of each person only to the extent that person's ownership is identical with respect to each organization, such persons are in effective control of each organization.

The five or fewer persons whose ownership is considered for purposes of the controlling interest requirement for each organization must be the same persons whose ownership is considered for purposes of the effective control requirement.

(2) *Controlling interest defined.* For purposes of this paragraph, the term ''controlling interest'' means:

(i) In the case of a corporation, ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of the shares of all classes of stock of the corporation;

(ii) In case of a trust or estate, ownership of an actuarial interest (determined under paragraph (f) of this section) of a least 80 percent of the trust or estate;

(iii) In the case of a partnership, ownership of at least 80 percent of the profit interest or capital interest of the partnership; and

(iv) In the case of a sole proprietorship, ownership of the sole proprietorship.

(3) *Effective control defined.* For purposes of this paragraph ''effective control'' means:

(i) In the case of a corporation, ownership of stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of the shares of all classes of stock of the corporation;

(ii) In the case of a trust or estate, ownership of an actuarial interest (determined under paragraph (f) of this section) of more than 50 percent of the trust or estate;

(iii) In the case of a partnership, ownership of more than 50 percent of the profit interest or capital interest of the partnership; and

(iv) In the case of a sole proprietorship, ownership of the sole proprietorship.

(e) *Combined group under common control.* The term ''combined group under common control'' means a group of three or more organizations, in which (1) each organization is a member of either a parent-subsidiary group under common control or brother-sister group under common control, and (2) at least one organization is the common parent organization of a parent-subsidiary group under common control and also a member of a brother-sister group under common control.

(f) *Actuarial interest.* For purposes of this section, the actuarial interest of each beneficiary of a trust or estate shall be determined by assuming the maximum exercise of discretion by the fiduciary in favor of the beneficiary. The factors and method prescribed in §20.2031–7 or, for certain prior periods, 20.2031–7A of this chapter (Estate Tax Regulations) for use in ascertaining the value of an interest in property for estate tax purposes will be used to determine a beneficiary's actuarial interest.

(g) *Exclusion of certain interests and stock in determining control.* In determining control under this paragraph, the term ''interest'' and the term ''stock'' do not include an interest that is treated as not outstanding under §1.414(c)–3. In addition, the term ''stock'' does not include treasury stock or nonvoting stock that is limited and preferred regarding dividends.

(h) *Transitional rule*—(1) *In general.* Paragraph (d) of this section, as amended by T.D. 8179, applies to all taxable years to which section 52(b) applies.

(2) *Election.* In the case of taxable years ending before March 2, 1988.

(i) If, pursuant to paragraph (b) of this section, an organization indicated in a timely filed return that it chose to be a member of a brother-sister group under common control, and it is not a member of such group because of the amendments to paragraph (d) of this section made by T.D. 8179 such organization may make the choice described in paragraph (b) of this section by filing an amended return on or before September 2, 1988 if such organization would otherwise still be a member of more than one group of trades or businesses under common control, and

(ii) If an organization—

(A) Is a member of a brother-sister group of trades or businesses under common control under §1.52–1(d)(1) as in effect before amendment by T.D. 8179 (''old group''), for such taxable year, and

(B) Is not such a member for such taxable year because of the amendments made by such Treasury decision,

such organization (whether or not a corporation) nevertheless will be treated as a member of such old group if all the organizations (whether or not corporations) that are members of the old group meet all the requirements of §1.1563–1(d)(3) with respect to such taxable year.

(Secs. 44B, 381, and 7805 of the Internal Revenue Code of 1954 (92 Stat. 2834, 26 U.S.C. 44B); 91 Stat. 148, 26 U.S.C. 381(c)(26); 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7553, 43 FR 31322, July 21, 1978, as amended by T.D. 7921, 48 FR 52904, Nov. 23, 1983; T.D. 7955, 49 FR 19975, May 11, 1984; T.D. 8179, 53 FR 6605, Mar. 2, 1988; 53 FR 8302, Mar. 14, 1988; 53 FR 16408, May 9, 1988; T.D. 8540, 59 FR 30102, June 10, 1994]

§ 1.52–2 Adjustments for acquisitions and dispositions.

(a) *General rule.* The provisions in this section only apply to the computation of the new jobs credit. If, after December 31, 1975, an employer acquires the major portion of a trade or business or the major portion of a separate unit of a trade or business, then, for purposes of computing the new jobs credit for any calendar year ending after the acquisition, both the amount of unemployment insurance wages and the amount of total wages considered to have been paid by the acquiring employer, for both the year in which the acquisition occurred and the preceding year, must be increased, respectively, by the amount of unemployment insurance wages and the amount of total wages paid by the predecessor employer that are attributable to the acquired portion of the trade or business or separate unit. If the predecessor employer informs the acquiring employer in writing of the amount of unemployment insurance wages and the amount of total wages attributable to the acquired portion of the trade or business that have been paid during the periods preceding the acquisition, then, for purposes of computing the credit for any calendar year ending after the acquisition the amount of unemployment insurance wages and the amount of total wages considered paid by the predecessor employer shall be decreased by those amounts. Regardless of whether the predecessor employer so informs the acquiring employer, the predecessor employer shall not be allowed a credit for the amount of any increase in the employment insurance wages or the total wages in the calendar year of the acquisition attributable to the acquired portion of the trade or business over the amount of such wages in the calendar year preceding the acquisition.

(b) *Meaning of terms*—(1) *Acquisition.* (i) For the purposes of this section, the term ''acquisition'' includes a lease agreement if the effect of the lease is to transfer the major portion of the trade or business or of a separate unit of the trade or business for the period of the lease. For instance, if one company leases a factory (including equipment) to another company for a 2-year period, the employees are retained by the second company, and the factory is used for the same general purposes as before, then for purposes of this section the lessee has acquired the lessor's trade or business for the period of the lease.

(ii) Neither the major portion of a trade or business nor the major portion of a separate unit of a trade or business is acquired merely by acquiring physical assets. The acquisition must transfer a viable trade or business.

(iii) Subdivision (ii) of this subparagraph may be illustrated by the following examples:

Example 1. R Co., a restaurant, sells its building and all its restaurant equipment to S Co. and moves into a larger, more modern building across the street. R Co. purchases new equipment, retains its name and continues to operate as a restaurant. S Co. opens a new restaurant in the old R Co. building. S Co. has merely acquired the old R Co. assets; it has not acquired any portion of R Co.'s business.

Example 2. The facts are the same as in *Example 1*, except that R Co. also sells its name and goodwill to S Co. and ceases to operate a restaurant business. S Co. operates its restaurant using the old R Co. name. In this situation, S Co. has acquired R Co.'s business.

(2) *Separate unit.* (i) A separate unit is a segment of a trade or business capable of operating as a self-sustaining enterprise with minor adjustments. The allocation of a portion of the goodwill of a trade or business to one of its segments is a strong indication that that segment is a separate unit.

(ii) The following examples are illustrations of the acquisition of a separate unit of a trade or business:

Example 1. The M Corp., which has been engaged in the sale and repair of boats, leases the repair shop building and all the property used in its boat repair operations to the N Co. for four years and gives the N Co. a covenant not to compete in the boat repair business for the period of the lease. The N Co. is considered to have acquired a separate unit of M Corp.'s business for the period of the lease.

Example 2. (a) The P Co. is engaged in the operation of a chain of department stores. There are eight divisions, each division is located in a different metropolitan area of the country, and each division operates under a different name. Although certain buying and merchandising functions are centralized, each division's day-to-day operations are independent of the others. The Q Corp. acquires all of the physical and intangible assets of one of the divisions, including the division's name. Other than making those minor adjustments necessary to give the division buying and merchandising departments, the Q Corp. allows the division to continue doing business in the same manner as it had been operating prior to the acquisition. The Q Corp. has acquired a separate unit of the P Co.'s business.

(b) The facts are the same as in paragraph (a) of example 2, except that Q Corporation buys the division merely to obtain its store locations. Before the Q Corporation takes over, the division liquidates its inventory in a going-out-of-business sale. The Q Corporation has merely acquired assets in this transaction, not a separate unit of P Company's business.

Example 3. The R Company processes and distributes meat products. Both the processing division and the distributorship are self-sustaining, profitable operations. The acquisition of either the meat processing division or the distributorship would be an acquisition of a separate unit of the R Company's business.

Example 4. The S Corporation is engaged in the manufacture and sale of steel and steel products. S Corporation also owns a coal mine, which it operates for the sole purpose of supplying its coal requirements for its steel manufacturing operations. The acquisition of the coal mine would be an acquisition of a separate unit of the S company's business.

Example 5. The T Company, which is engaged in the business of operating a chain of drug stores, sells its only downtown drug store to the V Company and agrees not to open another T Company store in the downtown area for five years. Included in the purchase price is an amount that is charged for the goodwill of the store location. The V Company has acquired a separate unit of the T Company's business.

Example 6. The W Company, which is engaged in the business of operating a chain of drug stores sells one of its stores to the X Company, but continues to operate another drug store three blocks away. The X Company opens the store doing business under its own name. The X Company has not acquired a separate unit of the W Company's business.

Example 7. (a) The Y Corporation, which is engaged in the manufacture of mattresses, sells one of its three factories to the Z Company. At the time of the sale, the factory is capable of profitably manufacturing mattresses on its own. Z Company has acquired a separate unit of the Y Corporation.

(b) The facts are the same as in (a) above, except that a profitable manufacturing operation cannot be conducted in the factory standing on its own. Z Company has not acquired a separate unit of the Y Corporation.

Example 8. The O Construction Company is owned by A, B, and C, who are unrelated individuals. It owns equipment valued at 1.5 million dollars and construction contracts valued at 6 million dollars. A, wishing to start his own company, exchanges his interest in O Company for 2 million dollars of contracts and a sufficient amount of equipment to enable him to begin business immediately. A has acquired a separate unit of the O Company's business.

(3) *Major portion.* All the facts and circumstances surrounding the transaction shall be taken into account in determining what constitutes a major portion of a trade or business (or separate unit). Factors to be considered include:

(i) The fair market value of the assets in the portion relative to the fair market value of the other assets of the trade or business (or separate unit);

(ii) The proportion of goodwill attributable to the portion of the trade or business (or separate unit);

(iii) The proportion of the number of employees of the trade or business (or separate unit) attributable to the portion in the periods immediately preceding the transaction; and

(iv) The proportion of the sales or gross receipts, net income, and budget of the trade or business (or separate unit) attributable to the portion.

(Secs. 44B, 381, and 7805 of the Internal Revenue Code of 1954 (92 Stat. 2834, 26 U.S.C. 44B); 91 Stat. 148, 26 U.S.C. 381(c)(26); 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7553, 43 FR 31323, July 21, 1978, as amended by T.D. 7921, 48 FR 52906, Nov. 23, 1983]

§ 1.52–3 Limitations with respect to certain persons.

(a) *Mutual savings institutions.* In the case of an organization to which section 593 applies (that is, a mutual savings bank, a cooperative bank or a domestic building and loan association), the amount of the targeted jobs credit (new jobs credit in the case of wages paid before 1979) allowable under section 44B shall be 50 percent of the amount otherwise determined under section 51, or, in the case of an organization under common control, under § 1.52–1 (a) and (b).

(b) *Regulated investment companies and real estate investment trusts.* In the case of a regulated investment company or a real estate investment trust subject to taxation under subchapter M, chapter 1 of the Code, the amount of the targeted jobs credit (new jobs credit in the case of wages paid before 1979) allowable under section 44B shall be reduced to the company's or trust's ratable share of the credit. The ratable share shall be determined in accordance with rules similar to the rules provided in section 46(e)(2)(B) and the regulations thereunder. For purposes of computing the ratable share, the reduction of the deduction for wage or salary expenses under § 1.280C–1 shall not be taken into account.

(c) *Cooperatives*—(1) *Taxable years ending after October 31, 1978.* For taxable years ending after October 31, 1978, in the case of a cooperative organization described in section 1381(a), rules similar to rules provided in section 46(h) and the regulations thereunder shall apply in determining the distribution of the amount of the targeted jobs credit (new jobs credit in the case of wages paid before 1979) allowable to the cooperative organization and its patrons under section 44B.

(2) *Taxable years ending before November 1, 1978.* For taxable years ending before November 1, 1978, in the case of a cooperative organization described in section 1381(a), the amount of new jobs credit allowable under section 44B shall be reduced to the cooperative's ratable share of the credit. The ratable share shall be the ratio which the taxable income of the cooperative for the taxable year bears to its taxable income increased by the amount of the deductions allowed under section 1382 (b) and (c). For purposes of computing the ratable share, the reduction of the deduction for wage or salary expenses under § 1.280C–1 shall not be taken into account.

(Secs. 44B, 381, and 7805 of the Internal Revenue Code of 1954 (92 Stat. 2834, 26 U.S.C. 44B); 91 Stat. 148, 26 U.S.C. 381(c)(26); 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7921, 48 FR 52906, Nov. 23, 1983]

§ 1.53–1 Limitation based on amount of tax.

(a) *General rule*—(1) *Targeted jobs credit.* For taxable years beginning after December 31, 1978, the amount of the targeted jobs credit allowed by section 44B (as amended by the Revenue Act of 1978) shall not exceed 90 percent of the tax imposed by chapter 1, reduced by the credits enumerated in section 53(a).

(2) *New jobs credit.* For taxable years beginning before January 1, 1979, the amount of the new jobs credit allowed by section 44B (as in effect prior to enactment of the Revenue Act of 1978) shall not exceed the tax imposed by chapter 1, reduced by the credits enumerated in section 53(a).

(b) *Special rule for 1978–79 fiscal year.* In the case of a taxable year beginning before January 1, 1979, and ending after that date, the sum of the targeted jobs credit (determined without regard to the tax liability limitation in paragraph (a)(1) of this section) and the new jobs credit (determined without regard to the tax liability limitation in (a)(2) of this section) shall not exceed the tax imposed by chapter 1, reduced by the credits enumerated in section 53(a).

(Secs. 44B, 381, and 7805 of the Internal Revenue Code of 1954 (92 Stat. 2834, 26 U.S.C. 44B); 91 Stat. 148, 26 U.S.C. 381(c)(26); 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7921, 48 FR 52906, Nov. 23, 1983]

§ 1.53–2 Carryback and carryover of unused credit.

(a) *Allowance of unused credit as a carryback or carryover*—(1) *In general.* Section 53(b) (formerly designated as section 53(c) for taxable years beginning before 1979) provides for carrybacks and carryovers of unused targeted jobs credit (new jobs credit in the case of wages paid before 1979). An unused credit is the excess of the credit determined under section 51 for the taxable year over the limitation provided by §1.53–1 for such taxable year. Subject to the limitations contained in paragraph (b) of this section and paragraph (f) of §1.53–3, an unused credit shall be added to the amount allowable as a credit under section 44B for the years to which an unused credit can be carried. The year with respect to which an unused credit arises shall be referred to in this section as the ''unused credit year.''

(2) *Taxable years to which unused credit may be carried.* An unused targeted jobs credit (new jobs credit in the case of wages paid before 1979) shall be a new employee credit carryback to each of the 3 taxable years preceding the unused credit year and a new employee credit carryover to each of the 15 taxable years succeeding the unused credit year. An unused credit must be carried first to the earliest of the taxable years to which it may be carried, and then to each of the other taxable years (in order of time) to the extent that the unused credit may not be added (because of the limitation contained in paragraph (b) of this section) to the amount allowable as a credit under section 44B for a prior taxable year.

(b) *Limitations on allowance of unused credit*—(1) *In general.* The amount of the unused targeted jobs credit (new jobs credit in the case of wages paid before 1979) from any particular unused credit year which may be added under section 53(b)(1) (section 53(c)(1) in the case of a new jobs credit) to the amount allowable as a credit under section 44B for any of the preceding or succeeding taxable years to which such credit may be carried shall not exceed the amount by which the limitation in §1.53–1 for such preceding or succeeding taxable year exceeds the sum of (i) the credit allowable under section 44B for such preceding or succeeding taxable year, and (ii) other unused credits carried to such preceding or succeeding taxable year which are attributable to unused credit years prior to the particular unused credit year. Thus, in determining the amount, if any, of an unused credit from a particular unused credit year which shall be added to the amount allowable as a credit for any preceding or succeeding taxable year, the credit earned for such preceding or succeeding taxable year, plus any unused credits originating in taxable years prior to the particular unused credit year, shall first be applied against the limitation based on amount of tax for such preceding or succeeding taxable year. To the extent the limitation based on amount of tax for the preceding or succeeding year exceeds the sum of the credit earned for such year and other unused credits attributable to years prior to the particular unused credit year, the unused credit from the particular unused credit year shall be added to the amount allowable as a credit under section 44B for such preceding or succeeding year. If any portion of the unused credit is a carryback to a taxable year beginning before January 1, 1977, section 44B shall be deemed to have been in effect for such taxable year for purposes of allowing such carryback as a credit under section 44B. To the extent that an unused credit cannot be added for a particular preceding or succeeding taxable year because of the limitation contained in this paragraph, such unused credit shall be available as a carryback or carryover to the next succeeding taxable year to which it may be carried.

(2) *Special rules for an electing small business corporation.* An unused targeted jobs credit (new jobs credit in the case of wages paid before 1979) under section 44B of a corporation which arises in an unused credit year for which the corporation is not an electing small business corporation (as defined in section 1371(b)) and which is a carryback or carryover to a taxable year for which the corporation is an electing small business corporation shall not be added to the amount allowable as a credit under section 44B to the shareholders of such corporation for any taxable year. However, a taxable year for which the corporation is an electing small business corporation shall be counted as a taxable year for purposes of determining the taxable years to which such unused credit may be carried.

(3) *Corporate acquisitions.* For the carryover of unused credits under section

44B in the case of certain corporate acquisitions, see section 381(c)(26) and § 1.381(c)(26)–1.

(4) *Examples.* This paragraph may be illustrated by the following examples.

Example 1. In 1978, A, a calendar year taxpayer, had an unused new jobs credit of $2,000. In 1979, A has a targeted jobs credit of $2,000 and a tax liability imposed by chapter 1 of the Code of $4,000 after all credits listed in section 53(a) have been taken into account. The amount of A's targeted jobs credit allowable under section 44B for 1979 is 90 percent of A's tax liability. The amount of the new jobs credit that may be carried to 1979 is limited to $1,600 ($3,600 [90% of $4,000] − $2,000).

Example 2. In 1979, B, a calendar year taxpayer, has a tax liability imposed by chapter 1 of the Code of $10,000 after all credits listed in section 53(a) have been taken. B's targeted jobs credit for that taxable year is limited to 90 percent of his income tax liability or $9,000. B had a $15,000 targeted jobs credit in 1979 resulting in an unused targeted jobs credit of $5,000 for that year. In 1976 and 1977 B had tax liabilities imposed by chapter 1 of the Code of $3,000 and $4,000 respectively after all credits listed in section 53(a) had been taken. For purposes of carrying back an unused targeted jobs credit to a taxable year beginning before January 1, 1977, section 44B as amended by the Revenue Act of 1978 is deemed to have been in effect for such taxable year. Accordingly, the applicable tax liability limitation for 1976 would be governed by section 53(a) (as amended by the Revenue Act of 1978) which limits the amount of targeted jobs credit allowed to 90 percent of the tax imposed by chapter 1 of the Code after all credits listed in section 53(a) have been taken. B may carry back $2,700 (90% of $3,000) of the 1979 unused targeted jobs credit to 1976. B may carry back $4,000 of the unused targeted jobs credit to 1977 because section 53(a) as it applied to the 1977 taxable year limited the amount of the credit to 100 percent of the taxpayer's tax liability imposed by chapter 1 of the Code after all credits listed in section 53(a) had been taken.

(Secs. 44B, 381, and 7805 of the Internal Revenue Code of 1954 (92 Stat. 2834, 26 U.S.C. 44B); 91 Stat. 148, 26 U.S.C. 381(c)(26); 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7921, 48 FR 52906, Nov. 23, 1983]

§ 1.53–3 Separate rule for pass-through of jobs credit.

(a) *In general.* Under section 53(b), in the case of a new jobs credit or targeted jobs credit earned under section 44B by a partnership, estate or trust, or subchapter S corporation, the amount of the credit that may be taken into account by a partner, beneficiary, or shareholder may not exceed a limitation under section 53(b) separately computed with respect to the partner's, beneficiary's, or shareholder's interest in the entity. A credit is subject to the limitation of section 53(b) with respect to a partner, beneficiary, or shareholder if it is earned by a partnership, estate or trust, or subchapter S corporation in a taxable year ending within, or ending before, a taxable year beginning before January 1, 1979 of the partner, beneficiary, or shareholder. See paragraph (f) of this section for rules on carryback or carryover of a credit subject to separate limitation. This section prescribes rules, under the authority of section 44B(b), relating to the computation of the separate limitation. For purposes of this section, references to section 53(a) and (b) are to that section as it existed before it was amended by the Revenue Act of 1978. This paragraph may be illustrated by the following examples:

Example 1. A, a calendar year taxpayer, is a partner in P, a calendar year partnership. A's pro rata portion of the credit earned by P in 1978 is $200. The $200 credit to be claimed on A's 1978 return is subject to the separate limitation in section 53(b) because the limitation applies to taxable years of the taxpayer beginning before January 1, 1979.

Example 2. B, a calendar year taxpayer, is a shareholder in Corporation M, a subchapter S corporation with a July to June fiscal year. B's pro rata portion of the credit earned by Corporation M in its taxable year beginning in 1978 is $100. The $100 credit to be claimed on B's 1979 return is not subject to the separate limitation requirement of section 53(b) because the limitation only applies to taxable years of the taxpayer beginning before 1979, notwithstanding the credit was earned by Corporation M before 1979.

(b) *Application of credit earned.* A credit earned under section 44B by a partnership, estate or trust, or subchapter S corporation shall be applied by a partner, beneficiary, or shareholder, to the extent allowed under section 53(b), before applying any other credit earned under section 44B. For example, if an individual has a new jobs credit from a proprietorship of $2,000 and from a partnership (after applying section 53(b)) of $1,800, but the credit must be limited under section

53(a) to $3,000, the entire $1,800 credit from the partnership would be applied before any part of the $2,000 amount is applied.

(c) *Amount of separate limitation.* The amount of the separate limitation is equal to the partner's, beneficiary's, or shareholder's limitation under section 53(a) for the taxable year multiplied by a fraction. The numerator of the fraction is the portion of the taxpayer's taxable income for the year attributable to the taxpayer's interest in the entity. The denominator of the fraction is the taxpayer's total taxable income for the year reduced by the zero bracket amount, if any.

(d) *Portion of taxable income attributable to an interest in a partnership, estate or trust, or subchapter S corporation*—(1) *General rule.* The portion of a taxpayer's taxable income attributable to an interest in a partnership, estate or trust, or subchapter S corporation is the amount of income from that entity the taxpayer is required to include in gross income, reduced by—

(i) The amount of the deductions allowed to the taxpayer that are attributable to the taxpayer's interest in the entity; and

(ii) A proportionate share of the deductions allowed to the taxpayer not attributable to a specific activity (as defined in paragraph (e)).

If a deduction comprises both an item that is attributable to the taxpayer's interest in the entity and an item or items that are not attributable to the interest in the entity, and if the deduction is limited by a provision of the Code (such as section 170(b), relating to limitations on charitable contributions), the deduction must be prorated among the items taken into account in computing the deduction. For example, if an individual makes a charitable contribution of $5,000 and his distributive share of a partnership includes $2,000 in charitable contributions made by the partnership, and if the charitable contribution deduction is limited to $3,500 under section 170(b), then the portion of the deduction allowed to the taxpayer that is not attributable to a specific activity is $2,500 ($3,500 × ($5,000 ÷ $7,000)) and the portion of the deduction allowed to the taxpayer that is attributable to the interest in the partnership is $1,000 ($3,500 × ($2,000 ÷ $7,000)).

(2) *Deductions attributable to an interest in an entity.* Examples of deductions that are attributable to the taxpayer's interest in an entity include (but are not limited to) a deduction under section 1202 attributable to a net capital gain passed through the entity, and a deduction attributable to a deductible item (such as a charitable contribution) that has been passed through the entity.

(3) *Computation of the proportionate share of deductions not attributable to a specific activity.* The proportionate share of a deduction of the taxpayer not attributable to a specific activity is obtained by multiplying the amount of the deduction by a fraction. The numerator of the fraction is the income from the entity that the taxpayer is required to include in gross income, reduced by the amount of the deductions of the taxpayer that are attributable to the taxpayer's interest in the entity. The denominator is the taxpayer's gross income reduced by the amount of all the deductions attributable to specific activities.

(4) *Examples.* The method of determining the amount of taxable income attributable to an interest in a partnership, estate or trust, or subchapter S corporation is illustrated by the following examples:

Example 1. (a) A, a single individual, is a shareholder in S Corporation, a subchapter S corporation. A is required to include the following amounts from S corporation is his gross income:

Salary	$3,000
Undistributed taxable income:	
Ordinary income	8,000
Net capital gain	2,000
Total	10,000
Total	13,000

A has income from other activities:

Ordinary income	6,000
Net capital gain	4,000
Total	10,000

(b) In order to determine the taxable income attributable to A's interest in S Corporation, it is necessary to reduce the amount of income from S Corporation that A is required to include in gross income by the amount of A's deductions attributable to the interest in S Corporation and by a proportionate share of A's deductions not attributable to a specific activity. These computations are made in paragraph (c) of this example. However, before the computation reducing A's income by a proportionate share of the deductions not attributable to a specific activity can be made, the ratio described in subparagraph (3) of this paragraph (d) must be determined. The numerator of the ratio (the amount of income from S Corporation that A is required to include in gross income, reduced by the amount of the deductions attributable to A's interest in S Corporation) is obtained in paragraph (c) of this example in the process of computing A's taxable income attributable to the interest in S Corporation. The determination of the denominator (A's gross income reduced by the amount of all deductions attributable to specific activities), however, require a separate computation, which follows:

Gross income:	
Income from S Corporation	$13,000
Income from other sources	10,000
Total	23,000
Less: Deductions attributable to specific activities:	
Section 1202 deduction (50 percent. of $6,000)	3,000
A's gross income reduced by the amount of the deductions attributable to specific activities (denominator of the ratio for determining the proportionate share of deductions not attributable to a specific activity)	20,000

(c) Computation of the amount of A's taxable income attributable to the interest in S Corporation:

Income from S Corporation that A is required to include in gross income:	
Ordinary income	$11,000
Net capital gain	2,000
Total	13,000
Less: Deductions of the taxpayer attributable to the interest in S Corporation:	
Section 1202 deduction (50 pct. of $2,000)	1,000
(Numerator of the ratio for determining the proportionate share of deductions not attributable to a specific activity)	12,000
Less: Proportionate share of the deductions of the taxpayer not attributable to a specific activity:	
Personal exemption deduction ($750 × $12,000/$20,000)	450
Zero bracket amount ($2,200 × $12,000/$20,000)	1,320
Total	1,770
Portion of A's taxable income attributable to interest in S Corporation.	10,230

Example 2. (a) C, a married individual with two children, is a partner in the CD Company. C's distributive share of the CD Company consists of the following:

Ordinary income (other than guaranteed payment)	$38,420
Guaranteed payment	20,000
Net long-term capital gain	6,000
Net short-term capital loss	2,000
Dividends qualifying for exclusion	100
Charitable contributions	500

C also has items of income from other sources and deductions, as follows:

Ordinary income	$21,680
Short-term capital gain	2,000
Dividends qualifying for exclusion	400
Deductions:	
Deductible medical expenses	16,000
Charitable contributions	4,000
Alimony	18,000
Interest and taxes on home	8,000
Loss relating to another specific activity	4,000

(b) In order to determine C's taxable income attributable to the interest in the partnership, it is necessary to reduce the amount of income from the partnership that C is required to include in gross income by the amount of C's deductions attributable to the interest in the partnership and by a proportionate share of C's deductions not attributable to a specific activity. These computations are made in paragraph (c) of this example. However, before the computation reducing C's income by a proportionate share of the deductions not attributable to a specific activity can be made, the ratio described in paragraph (d)(3) of this section must be determined. The numerator of the ratio is determined in paragraph (c) of this example in the process of computing C's taxable income attributable to the interest in the partnership. The denominator, however, requires a separate computation, reducing C's gross income by the amount of all deductions attributable to specific activities. This computation is as follows:

Gross income: Income from the partnership:	
Ordinary income	$58,420
Net long-term capital gain	6,000
Dividends	100
Less: Proportionate share of dividend exclusion ($100 × $100/$500)	20
	80
	64,500
Income from other sources:	
Ordinary income	21,680
Net short/term capital gain	2,000
Dividends	400
Less: Proportionate share of dividend exclusion ($100 × $400/$500)	$80
	320
	24,000
	88,500
Less: Deductions attributable to specific activities:	
Net short-term capital loss passed through the partnership	2,000

Loss related to another specific activity	4,000
Section 1202 deduction attributable to the interest in the partnership	2,000
Charitable contribution deduction passed through the partnership	500
	8,500
C's gross income, reduced by the amount of the deductions attributable to specific activities (denominator of the ratio for determining the proportionate share of deductions not attributable to a specific activity)	80,000

(c) Computation of the amount of C's taxable income attributable to the interest in the partnership:

Distributive share of ordinary income (other than guaranteed payments)	$38,420
Guaranteed payment	20,000
Distributive share of dividends less share of exclusion	80
Distributive share of net long-term capital gain	6,000
	64,500
Section 1202 deduction (50 pct. of $4,000)	2,000
Charitable contribution passed through the partnership	500
Net short-term capital loss passed through the partnership	2,000
	4,500
(Numerator of the ratio for determining the proportionate share of deductions not attributable to a specific activity)	60,000
Section 1202 deduction ($1,000 × $60,000/$80,000)	750
Deductible medical expenses ($16,000 × $60,000/$80,000)	12,000
Charitable contributions ($4,000 × $60,000/$80,000)	3,000
Alimony ($18,000 × $60,000/$80,000)	13,500
Interest and taxes on home ($8,000 × $60,000/$80,000)	6,000
Personal exemption deduction ($3,000 × $60,000/$80,000)	2,250
Total	37,500
Portion of C's taxable income attributable to the interest in the partnership	22,500

C has a deduction under section 1202 of $3,000. Of that deduction, $2,000 is attributable directly to C's interest in the partnership (50 percent of the net capital gain that would result from offsetting the $6,000 net long-term capital gain and the $2,000 net short-term capital loss that are attributable to C's interest in the partnership). Since the remaining $1,000 deduction under section 1202 cannot be attributed directly to either C's income from the partnership or any other specific activity, it must be treated as a deduction not attributable to a specific activity.

(e) *Deductions not attributable to a specific activity*—(1) *Specific activity defined.* A specific activity means a course of continuous conduct involving a particular line of endeavor, whether or not the activity is carried on for profit. Examples of a specific activity are:

(i) A trade or business carried on by the taxpayer;

(ii) A trade or business carried on by an entity in which the taxpayer has an interest;

(iii) An activity with respect to which the taxpayer is entitled to a deduction under section 212;

(iv) The operation of a farm as a hobby.

(2) *Types of deductions not attributable to a specific activity*. Examples of deductions not attributable to a specific activity include charitable contributions made by the partner, beneficiary, or shareholder; medical expenses; alimony; interest on personal debts of the partner, beneficiary, or shareholder; and real estate taxes on the personal residence of the partner, beneficiary, or shareholder. For purposes of this section, in cases in which deductions are not itemized, the zero bracket amount is considered to be a deduction not attributable to a specific activity.

(f) *Carryback or carryover of credit subject to separate limitation*. A credit subject to the separate limitation under section 53(b) that is carried back or carried over to a taxable year beginning before January 1, 1979, is also subject to the separate limitation in the carryback or carryover year. For purposes of the preceding sentence, a credit that is earned by a partnership, a trust, or estate, or a subchapter S corporation in a taxable year of such entity ending within, or after, the taxable year of a partner beneficiary or shareholder beginning after December 31, 1978, will not be subject to the separate limitation in section 53(b) with respect to such partner, beneficiary, or shareholder. The taxpayer to whom the credit has been passed through shall not be prevented from applying the unused portion in a carryback or carryover year merely because the entity that earned the credit changes its form of conducting business if the nature of its trade or business essentially remains the same. The computation of the separate limitation in such a case shall reflect the income attributable to the taxpayer's interest in the entity in its revised form. Thus, a shareholder carrying over a credit from a subchapter S corporation may include dividends declared by that corporation after the subchapter S election had been terminated as income attributable to that person's interest in the entity. Similarly, if a partnership incorporates in a carryover year, any income attributable to an interest in the corporation will be regarded, for purposes of computing the separate limitation under section 53(b), as income attributable to an interest in the entity. This paragraph may be illustrated by the following examples:

Example 1. A, a calendar year taxpayer, is a shareholder in Corporation M, a subchapter S corporation. In 1977, A's pro rata share of the new jobs credit earned by Corporation M was $10,000. A could only use $2,000 of the credit in 1977 because of the separate limitation under section 53(b). In 1978, A carries the unused credit over from 1977. The carryover credit is subject to the separate limitation under section 53(b).

Example 2. Assume the same facts as in example 1 except that the unused credit is carried over to 1979. The carryover credit is not subject to the separate limitation under section 53(b) because that limitation does not apply to taxable years of a taxpayer beginning after December 31, 1978.

Example 3. B, a calendar year taxpayer, is a shareholder in Corporation W, a subchapter S corporation. In 1979, B's pro rata share of the targeted jobs credit covered by Corporation W was $5,000 but B could only use $3,000 of the credit in 1979. B carries back the unused credit to 1978. The carryback credit is not subject to the separate limitation under section 53(b).

(Secs. 44B, 381, and 7805 of the Internal Revenue Code of 1954 (92 Stat. 2834, 26 U.S.C. 44B); 91 Stat. 148, 26 U.S.C. 381(c)(26); 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7560, 43 FR 60445, Dec. 28, 1978. Redesignated and amended by T.D. 7921, 48 FR 52906, 52907, Nov. 23, 1983]

§ 1.55–1 Alternative minimum taxable income.

(a) *General rule for computing alternative minimum taxable income.* Except as otherwise provided by statute, regulations, or other published guidance issued by the Commissioner, all Internal Revenue Code provisions that apply in determining the regular taxable income of a taxpayer also apply in determining the alternative minimum taxable income of the taxpayer.

(b) *Items based on adjusted gross income or modified adjusted gross income.* In determining the alternative minimum taxable income of a taxpayer other than a corporation, all references to the taxpayer's adjusted gross income or modified adjusted gross income in determining the amount of items of income, exclusion, or deduction must be treated as references to the taxpayer's adjusted gross income or modified adjusted gross income as determined for regular tax purposes.

(c) *Effective date.* These regulations are effective for taxable years beginning after December 31, 1993.

[T.D. 8569, 59 FR 60557, Nov. 25, 1994]

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[T.D. 8307, 55 FR 33675, Aug. 17, 1990, as amended by T.D. 9347, 72 FR 44347, Aug. 7, 2007]

§ 1.56–1 Adjustment for the book income of corporations.

(a) *Computation of the book income adjustment*—(1) *In general.* For taxable years beginning in 1987, 1988, and 1989, the alternative minimum taxable income of any taxpayer is increased by the book income adjustment described in this paragraph (a)(1). The book income adjustment is 50 percent of the excess, if any, of—

(i) The adjusted net book income (as defined in paragraph (b) of this section) of the taxpayer, over

(ii) The pre-adjustment alternative minimum taxable income for the taxable year.

For purposes of this section, pre-adjustment alternative minimum taxable income is alternative minimum taxable income, determined without regard to the book income adjustment or the alternative tax net operating loss determined under section 56(a)(4). See paragraph (a)(4) of this section for examples relating to the computation of the income adjustment.

(2) *Taxpayers subject to the book income adjustment.* The book income adjustment is applicable to any corporate taxpayer that is not an S corporation, regulated investment company (RIC), real estate investment trust (REIT), or real estate mortgage investment company (REMIC).

(3) *Consolidated returns.* In the case of a taxpayer that is a consolidated group, the book income adjustment equals 50 percent of the amount, if any, by which its consolidated adjusted net book income (as defined in paragraph (b)(3)(i) of this section) exceeds its consolidated pre-adjustment alternative minimum taxable income (as defined in paragraph (b)(3)(iii) of this section). See paragraph (a)(4), Example 4 of this section. For purposes of this section, with respect to any taxable year the term ''consolidated group'' has the same meaning as in § 1.1502–1T. See paragraph (d)(6) of this section for rules relating to adjustments attributable to related corporations.

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

Example 1. Corporation A has adjusted net book income of $200 and pre-adjustment alternative minimum taxable income of $100. A must increase its pre-adjustment alternative minimum taxable income by $50 (($200–$100) × .50).

Example 2. Corporation B has adjusted net book income of $200 and pre-adjustment alternative minimum taxable income of $300. B does not have a book income adjustment for the taxable year because its adjusted net book income does not exceed its pre-adjustment alternative minimum taxable income.

Example 3. Corporation C has adjusted net book income of negative $200 and pre-adjustment alternative minimum taxable income of negative $300. C must increase its pre-adjustment alternative minimum taxable income by $50 ((−$200 − (−$300)) × .50). Thus, C's alternative minimum taxable income determined after the book income adjustment, but without regard to the alternative tax net operating loss, is negative $250 (−$300 + $50).

Example 4. Corporations D and E are a consolidated group for tax purposes. D and E do not have a consolidated financial statement. On their separate financial statements D and E have adjusted net book income of $100 and $50 respectively, and pre-adjustment alternative minimum taxable income of $50 and $80 respectively. Assuming there are no intercompany transactions, DE's consolidated adjusted net book income (as defined in paragraph (b)(3)(i) of this section) is $150 and its consolidated pre-adjustment alternative minimum taxable income (as defined in paragraph (b)(3)(iii) of this section) is $130.

DE must increase its consolidated pre-adjustment alternative minimum taxable income by $10 (($150 − $130) × .50).

(b) *Adjusted net book income*—(1) *In general.* ''Adjusted net book income'' means the net book income (as defined in paragraph (b)(2) of this section) adjusted as provided in paragraph (d) of this section. Except as provided in paragraph (d) of this section, a taxpayer may not make any adjustments to net book income.

(2) *Net book income*—(i) *In general.* ''Net book income'' means the income or loss for a taxpayer reported in the taxpayer's applicable financial statement (as defined in paragraph (c) of this section). Net book income must take into account all items of income, expense, gain and loss of the taxable year, including extraordinary items, income or loss from discontinued operations, and cumulative adjustments resulting from accounting method changes. Net book income is not reduced by any distributions to shareholders. See paragraph (b)(5)(i) of this section for a similar rule for corporations using current earnings and profits to compute net book income.

(ii) *Measures of net book income.* Except as described in paragraph (b)(5) of this section, net book income is disclosed on the income statement included in a taxpayer's applicable financial statement. Such income statement must reconcile with the balance sheet, if any, that is included in the applicable financial statement and must be used in computing changes in owner's equity reflected in the applicable financial statement. See paragraph (c) of this section for the definition of an applicable financial statement.

(iii) *Tax-free transactions and tax-free income.* Net book income includes income or loss that is reported on a taxpayer's applicable financial statement regardless of whether such income or loss is recognized, realized or otherwise taken into account for other Federal income tax purposes. See paragraph (b)(7), Examples 1, 2 and 3 of this section.

(iv) *Treatment of dividends and other amounts.* The adjusted net book income of a taxpayer shall include the earnings of other corporations not filing a consolidated Federal income tax return with the taxpayer only to the extent that amounts are required to be included in the taxpayer's gross income under chapter 1 of the Code with respect to the earnings of such other corporation (e.g., dividends received from such corporation and amounts included under subpart A). See paragraph (b)(7), Examples 4 and 5 of this section.

(3) *Additional rules for consolidated groups*—(i) *Consolidated adjusted net book income.* ''Consolidated adjusted net book income'' means the consolidated net book income (as defined in paragraph (b)(3)(ii) of this section), after taking into account the adjustments under the rules of paragraph (d) of this section.

(ii) *Consolidated net book income.* Consolidated net book income is the income or loss of a consolidated group as reported on its applicable financial statement as defined in paragraph (c)(5) of this section.

(iii) *Consolidated pre-adjustment alternative minimum taxable income.* Consolidated pre-adjustment alternative minimum taxable income is the taxable income of the consolidated group for the taxable year, determined with the adjustments provided in sections 56 and 58 (except for the book income adjustment and the alternative tax net operating loss determined under section 56(a)(4)) and increased by the preference items described in section 57.

(iv) *Cross references.* See paragraph (c)(5) of this section for rules relating to the applicable financial statement of related corporations and paragraph (d)(6) of this section for rules relating to adjustments attributable to related corporations.

(4) *Computation of adjusted net book income when taxable year and financial accounting year differ*—(i) *In general.* If a taxpayer's applicable financial statement is prepared on the basis of a financial accounting year that differs from the year that the taxpayer uses for filing its Federal income tax return, adjusted net book income must be computed either—

(A) By including a pro rata portion of the adjusted net book income for each financial accounting year that includes any part of the taxpayer's taxable year (see paragraph (b)(7), Example 6 of this section), or

(B) In accordance with the election described in paragraph (b)(4)(iii) of this section.

(ii) *Estimating adjusted net book income.* If a taxpayer is using the pro rata approach described in paragraph (b)(4)(i)(A) of this section and an applicable financial statement for part of the taxpayer's taxable year is not available when the taxpayer files its Federal income tax return, the taxpayer must make a reasonable estimate of adjusted net book income for the pro rata portion of the taxable year. If the actual pro rata portion of adjusted net book income that results from the taxpayer's applicable financial statement for the financial accounting year exceeds the estimate of adjusted net book income used on the original tax return and results in additional tax liability, the taxpayer must file an amended Federal income tax return reflecting such additional liability. The amended return must be filed within 90 days of the date the previously unavailable applicable financial statement is available.

(iii) *Election to compute adjusted net book income based on the financial statement for the year ending within the taxable year*—(A) *In general.* If a taxpayer's accounting year ends five or more months after the end of its taxable year, the taxpayer may elect to compute adjusted net book income based on the net book income reported on the applicable financial statement prepared for the financial accounting year ending within the taxpayer's taxable year. See paragraph (b)(7), Examples 7 and 8 of this section. For purposes of this paragraph (b)(4)(iii)(A), if a taxpayer uses a 52–53 week year for financial accounting or Federal income tax purposes, the last day of such year shall be deemed to occur on the last day of the calendar month ending closest to the end of such year.

(B) *Time of making election.* An election under this paragraph (b)(4)(iii) is made by attaching the statement described in paragraph (b)(4)(iii)(C) of this section to the taxpayer's Federal income tax return for the first taxable year in which the taxpayer is eligible to make the election. An election under this paragraph (b)(4)(iii) that is made prior to the first taxable year in which the taxpayer is eligible to make the election (as determined under paragraph (b)(4)(iii)(C) of this section) is valid unless revoked pursuant to paragraph (b)(4)(iii)(D) of this section.

(C) *Eligibility to make and manner of making election.* A taxpayer is eligible to make the election specified in paragraph (b)(4)(iii)(A) of this section in the first taxable year beginning after 1986 in which—

(*1*) The taxpayer has an accounting year ending five or more months after the end of its taxable year,

(*2*) The use of the pro rata approach described in paragraph (b)(4)(i)(A) of this section produces an excess of adjusted net book income over pre-adjustment alternative minimum taxable income, as defined in paragraph (a)(1) of this section, and

(*3*) The taxpayer has an excess of tentative minimum tax over regular tax for the taxable year, as defined in section 55(a), or is liable for the environmental tax imposed by section 59A.

Thus, a taxpayer is not required to evaluate the merits of an election to compute its adjusted net book income based on the applicable financial statement prepared for the financial accounting year ending within the taxpayer's taxable year unless the taxpayer, when using the pro rata approach described in paragraph (b)(4)(i)(A) of this section, either has an excess of tentative minimum tax over its regular tax or is liable for the environmental tax imposed by section 59A. The election statement must set forth the electing taxpayer's name, address, taxpayer identification number, taxable year and financial accounting year. An election under this paragraph (b)(4)(iii) will apply for the taxable year when initially made and for all subsequent years until revoked with the consent of the District Director.

(D) *Election or revocation of election made on an amended return.* An election under paragraph (b)(4)(iii) of this section may be made by attaching the statement described in paragraph (b)(4)(iii)(C) to an amended return for the first taxable year in which the taxpayer is eligible to make the election. An election under paragraph (b)(4)(iii) of this section that was made prior to the first taxable year in which the taxpayer was eligible to make the election, as determined under paragraph (b)(4)(iii)(C) of this section, may be revoked by filing an amended return for the taxable year in which the election was initially made. However, an election made or revoked on an amended return under paragraph (b)(4)(iii) of this section will be allowed only if the amended return is filed no later than December 14, 1990.

(iv) *Quarterly statement filed with the Securities and Exchange Commission (SEC)*. A taxpayer with different financial accounting and taxable years that is required to file both annual and quarterly financial statements with the SEC may not aggregate quarterly statements filed with the SEC in order to obtain a statement covering the taxpayer's taxable year. See paragraph (b)(7), Example 9 of this section. See paragraph (c)(3)(iv)(B)(*1*) of this section for priority rules relating to statements required to be filed with the SEC.

(5) *Computation of net book income using current earnings and profits*—(i) *In general*. If a taxpayer does not have an applicable financial statement, or only has a statement described in paragraph (c)(1)(iv) of this section and makes the election described in paragraph (c)(2) of this section, net book income for purposes of this section is equal to the taxpayer's current earnings and profits for its taxable year. Generally, a taxpayer's current earnings and profits is computed under the rules of section 312 and the regulations thereunder. Current earnings and profits therefore is reduced by Federal income tax expense and any foreign tax expense for foreign taxes eligible for the foreign tax credit under section 27 of the Code. Current earnings and profits is then adjusted as described in paragraph (d) of this section to arrive at adjusted net book income. No adjustment is made under paragraph (d) of this section, however, for any adjustment that is already reflected in current earnings and profits. See paragraph (d)(3) of this section for adjustments to net book income with respect to certain taxes. For purposes of this section, current earnings and profits is not reduced by any distribution to shareholders. See paragraph (d)(3)(iv), Example 5 of this section.

(ii) *Current earnings and profits of a consolidated group*. For purposes of this paragraph (b)(5), the current earnings and profits of a consolidated group is the aggregate of the current earnings and profits of each member of the group, as determined pursuant to paragraph (d)(4)(iii) of this section.

(6) *Additional rules for computation of net book income of a foreign corporate taxpayer*—(i) *Adjusted net book income of a foreign taxpayer*. Adjusted net book income of a foreign corporate taxpayer (''foreign taxpayer'') means the effectively connected net book income (as defined in paragraph (b)(6)(ii) of this section) of the foreign taxpayer, after taking into account the adjustments under the rules of paragraph (d) of this section.

(ii) *Effectively connected net book income of a foreign taxpayer*—(A) *In general*. Effectively connected net book income of a foreign taxpayer is the income or loss reported in its applicable financial statement (as defined in paragraph (c)(5)(ii) of this section), but only to the extent that such amount is attributable to items of income or loss that would be treated as effectively connected with the conduct of a trade or business in the United States by the foreign taxpayer as determined under either the principles of section 864(c) and the regulations thereunder, or any other applicable provision of the Internal Revenue Code of 1986. Thus, if for tax purposes an item of income or loss is treated as effectively connected with the conduct of a trade or business in the United States, then the income or loss reported on the foreign taxpayer's applicable financial statement attributable to such item is effectively connected net book income. See paragraph (b)(7), Examples 11, 12 and 13 of this section.

(B) *Certain exempt amounts*. Effectively connected net book income does not include any amount attributable to an item that is exempt from United States taxation under sections 883, 892, 894 or 895 of the Internal Revenue Code of 1986. See paragraph (b)(7), Examples 14 and 15 of this section.

(iii) *Computation of net book income of a foreign taxpayer using current earnings* *and profits.* If a foreign taxpayer does not have an applicable financial statement or only has a statement described in paragraph (c)(1)(iv) of this section and makes the election described in paragraph (c)(2) of this section, net book income for purposes of this section is equal to the foreign taxpayer's current earnings and profits that are attributable to income or loss that is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States. Effectively connected current earnings and profits are computed under the rules of section 884(d) and the regulations thereunder, relating to effectively connected earnings and profits for purposes of computing the branch profits tax, but without regard to the exceptions set forth under section 884(d)(2)(B) through (E). For purposes of this section, effectively connected current earnings and profits are not reduced by any remittances or distributions. Effectively connected current earnings and profits takes into account Federal income tax expense and any foreign tax expense; however, see paragraph (d)(3) of this section for adjustments to net book income with respect to certain taxes.

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

Example 1. Corporation A owns 100 percent of corporation B and the AB affiliated group files a consolidated Federal income tax return. AB uses a calendar year for both financial accounting and tax purposes. During 1987, A transfers all of its stock in B for stock on an acquiring corporation in a transaction described in section 368(a)(1)(B). Although AB recognizes no taxable gain on the transfer pursuant to section 354, gain from the transfer is reported on AB's 1987 applicable financial statement. Pursuant to paragraph (b)(2)(iii) of this section, AB's net book income includes the book gain attributable to the transfer.

Example 2. Corporation C uses a calendar year for both financial accounting and tax purposes. C adopted a plan of liquidation prior to August 1, 1986. On June 1, 1987, C makes a bulk sale of all of its assets subject to liabilities and completely liquidates. Pursuant to section 633(c) of the Tax Reform Act of 1986 (the Act), section 337, as in effect prior to its amendment by the Act, applies. Thus, C will generally not recognize taxable gain upon the bulk sale. However, C's applicable financial statement for the period January 1, 1987 through June 1, 1987, reports net book income of $500, $400 of which is attributable to the bulk sale of assets on June 1, 1987. Pursuant to paragraph (b)(2)(iii) of this section, C's net book income includes the amount attributable to the bulk sale. Thus, assuming C has no other adjustments to net book income, its adjusted net book income for the period January 1, 1987 through June 1, 1987, is $500.

Example 3. Corporation Z has a large inventory of marketable securities. On its applicable financial statement, Z marks these securities to market, *i.e.*, as they appreciate in value, Z restates their value on its balance sheet to their fair market value, and increases the income on its income statement by that amount. Pursuant to paragraph (b)(2)(iii) of this section, the adjusted net book income of Z includes the income from the valuation adjustment.

Example 4. Corporation D owns 100 percent of E, a controlled foreign corporation as defined in section 957. Both D and E use a calendar year for financial accounting and tax purposes. D's applicable financial statement includes E. Pursuant to section 951, D includes $100 of E's subpart F income in its gross income for 1987. Although D's applicable financial statement is adjusted to eliminate E's income, pursuant to paragraph (b)(2)(iv) of this section, D's adjusted net book income for 1987 includes the $100 of gross income included under section 951.

Example 5. Corporation F owns 20 percent of G, a foreign corporation. Both F and G use a calendar year for financial accounting and tax purposes. During 1987, G pays F a $100 dividend. F's applicable financial statement accounts for F's investment in G by the equity method. F is eligible for a deemed paid foreign tax credit of $30 with respect to the dividend from G and must include the $130 in gross income pursuant to section 78 of the Code. Although F's applicable financial statement is adjusted to eliminate F's income from G under the equity method, pursuant to paragraph (b)(2)(iv) of this section, F's adjusted net book income for 1987 includes the $130 of gross income recognized with respect to the dividend from G.

Example 6. Corporation H files its Federal income tax return on a calendar year basis. However, its applicable financial statement is based on a fiscal year ending June 30. H does not make the election described in paragraph (b)(4)(iii) of this section. Pursuant to paragraph (b)(4)(i) of this section, H's adjusted net book income for calendar year 1987 is computed by adding 50 percent of adjusted net book income from the applicable financial statement for the year ending June 30, 1987 and 50 percent of adjusted net book income from the applicable financial statement for the year ending June 30, 1988.

Example 7. Corporation J files its Federal income tax returns for 1987, 1988, and 1989 on a calendar year basis. However, its applicable financial statement is based on a year ending May 31. Pursuant to paragraph (b)(4)(iii) of this section, J elects in 1987 to compute its adjusted net book income by using the applicable financial statement for the fiscal year ending May 31, 1987. Unless the District Director consents to revocation of the election, for calendar year 1988 or 1989, J's adjusted net book income for 1988 and 1989 is determined from its applicable financial statements for the years ending May 31, 1988 and May 31, 1989, respectively.

Example 8. The facts are the same as in Example 7, except that J's applicable financial statement is based on a year ending April 30. Since April 30, is less than 5 months after December 31, the end of J's taxable year, J is not permitted to make the election described in paragraph (b)(4)(iii) of this section.

Example 9. The facts are the same as in Example 8, except H files quarterly and annual financial statements with the Securities and Exchange Commission (SEC). The fourth quarter statement is included as a footnote to the annual statement that it files with the SEC. Pursuant to paragraph (b)(4)(iv) of this section, H may not determine its net book income by aggregating its four quarterly statements for 1987. Thus, H's net book income is computed as described in Example 8.

Example 10. Corporation I is a United States corporation with a 100 percent owned subsidiary, J, a foreign sales corporation (FSC). I uses a calendar year for both financial accounting and tax purposes. Income from J is consolidated in I's applicable financial statement. I and J do not file a consolidated tax return. In 1987, J pays a dividend to I of $100 out of J's earnings and profits. For purposes of this example, it is assumed that the distribution is made out of the profits attributable solely to foreign trade income determined through use of the administrative pricing rules of section 925(a) (1) and (2). Accordingly, the distribution is eligible for the 100 percent dividends received deduction under section 245(c). Although I's applicable financial statement is adjusted to eliminate income or loss attributable to J, the entire amount of the dividend distribution must be included in I's adjusted net book income pursuant to paragraph (b)(2)(iv) of this section.

Example 11. Corporation K is a foreign corporation incorporated under the laws of country X. K uses a calendar year for both financial accounting and tax purposes. In 1987, K actively conducts a real estate business, L, in the United States. The financial statement that is used as K's applicable financial statement (as determined under paragraph (c)(5)(ii) of this section) discloses total net income of $150. Of this amount, $100 is attributable to L's real estate business and $50 is attributable to dividends paid to L from its investment in certain securities. The securities investment is not connected with L's real estate business. Under the rules of section 864, only $100 is effectively connected to the conduct of a trade or business in the United States. Thus, K's effectively connected net book income for 1987 equals $100.

Example 12. Assume the same facts as in Example 11 except that K's applicable financial statement also discloses $75 attributable to investment real property located in the United States, so that the net income amount reported on the financial statement equals $225. The $75 of income is not effectively connected with the conduct of a trade or business in the United States. K, for regular tax purposes, makes an election under section 882(d) to treat this income as effectively connected with the conduct of a trade or business in the United States. As a result, K's effectively connected net book income for 1987 equals $175 ($100 + $75).

Example 13. Corporation M is a foreign corporation that actively conducts a manufacturing business, N, in the United States. M is a calendar year taxpayer for both financial accounting and tax purposes. In 1987, the financial statement that is used as M's applicable financial statement (as determined under paragraph (c)(5)(ii) of this section) reflects an anticipated loss from the sale of a division of N. For Federal income tax purposes the loss is not recognized in 1987, but rather is recognized in 1988 when M sells the division. In determining M's effectively connected net book income for 1987, the anticipated loss reported on M's 1987 applicable financial statement is taken into account because the reported loss is effectively connected to the conduct of a trade or business in the United States under the principles of section 864.

Example 14. Corporation O is a foreign corporation that is engaged in the international shipping business. O is incorporated under the laws of X. O is a calendar year taxpayer for both financial accounting and tax purposes. In 1987, O actively conducts a shipping business, P, within the United States. The statement that is used in 1987 as O's applicable financial statement (as determined under paragraph (c)(5)(ii) of this section) discloses income of $100 that is attributable to P's operation of ships in international traffic. Under section 864, $50 is effectively connected with the conduct of a trade or business in the United States. However, the United States income tax treaty with X exempts from United States income tax any income derived by a resident of X from the operation of ships in international traffic. Thus, pursuant to paragraph (b)(6)(ii)(B) of this section, no amount of P's income is includible in O's effectively connected net book income.

Example 15. Assume the same facts as in Example 14 except that there is no United

States income tax treaty with X. However, X by statute exempts United States citizens and United States corporations from tax imposed by X on gross income derived from the operation of a ship or ships in international traffic. Under section 883(a), P's income of $50 that is effectively connected with the conduct of a trade or business in the United States is exempt from United States taxation. Thus, pursuant to paragraph (b)(6)(ii)(B) of this section, no amount of P's income is includible in O's effectively connected net book income.

(c) *Applicable Financial Statement*—(1) *In general.* A taxpayer's applicable financial statement is the statement described in this paragraph (c)(1) that has the highest priority, as determined under paragraph (c)(3) of this section. Generally, an applicable financial statement includes an income statement, a balance sheet (listing assets, liabilities, and owner's equity including changes thereto), and other appropriate information. An income statement alone may constitute an applicable financial statement for purposes of this section if the other materials described in this paragraph are not prepared or used by the taxpayer. However, an income statement that does not reconcile with financial materials otherwise issued will not qualify as an applicable financial statement. For purposes of determining the book income adjustment, the following may be considered applicable financial statements (subject to the rules relating to priority among statements under paragraph (c)(3) of this section)—

(i) *Statement required to be filed with the Securities and Exchange Commission (SEC).* A financial statement that is required to be filed with the Securities and Exchange Commission.

(ii) *Certified audited financial statement.* A certified audited financial statement that is used for credit purposes, for reporting to shareholders or for any other substantial non-tax purpose. Such a statement must be accompanied by the report of an independent (as defined in the American Institute of Certified Public Accountants Professional Standards, Code of Professional Conduct, Rule 101 and its interpretations and rulings) Certified Public Accountant or, in the case of a foreign corporation, a similarly qualified and independent professional who is licensed in any foreign country. A financial statement is ''certified audited'' for purposes of this section if it is—

(A) Certified to be fairly presented (an unqualified or ''clean'' opinion),

(B) Subject to a qualified opinion that such financial statement is fairly presented subject to a concern about a contingency (a qualified ''subject to'' opinion),

(C) Subject to a qualified opinion that such financial statement is fairly presented, except for a method of accounting with which the accountant disagrees (a qualified ''except for'' opinion), or

(D) Subject to an adverse opinion, but only if the accountant discloses the amount of the disagreement with the statement.

Any other statement or report, such as a review statement or a compilation report that is not subject to a full audit is not a certified audited statement. See paragraph (c)(3)(iv)(B)(*2*) of this section for a special rule for a statement accompanied by a review report when there are statements of equal priority. See also paragraph (d)(5)(iii) of this section for rules relating to adjustments for information disclosed in an accountant's opinion to a certified audited statement.

(iii) *Financial statement provided to a government regulator.* A financial statement that is required to be provided to the Federal government or any agency thereof (other than the Securities and Exchange Commission), a state government or any agency thereof, or a political subdivision of a state or any agency thereof. An income tax return, franchise tax return or other tax return prepared for the purpose of determining any tax liability that is filed with a Federal, state or local government or agency cannot be an applicable financial statement.

(iv) *Other financial statements.* A financial statement that is used for credit purposes, for reporting to shareholders, or for any other substantial non-tax purpose, even though such financial statement is not described in paragraphs (c)(1)(i) through (c)(1)(iii) of this section.

(v) *Required use of current earnings and profits.* If a taxpayer does not have a financial statement described in paragraphs (c)(1)(i) through (c)(1)(iv) of this section, the taxpayer does not have an applicable financial statement. In that case, net book income for the taxable year will be treated as being equal to the taxpayer's current earnings and profits for the taxable year. See paragraph (b)(5) of this section for rules relating to the computation of current earnings and profits for the taxable year. See paragraph (c)(4) of this section for rules relating to use of a financial statement for a substantial non-tax purpose.

(2) *Election to treat net book income as equal to current earnings and profits for the taxable year*—(i) *In general.* If a taxpayer's only financial statement is a statement described in paragraph (c)(1)(iv) of this section, the taxpayer may elect to treat net book income as equal to the taxpayer's current earnings and profits for all taxable years in which the taxpayer is eligible to make the election.

(ii) *Time of making election.* An election under this paragraph (c)(2) is made by attaching the statement described in paragraph (c)(2)(iii) of this section to the taxpayer's Federal income tax return for the first taxable year the taxpayer is eligible to make the election. An election under this paragraph (c)(2), which is made prior to the first taxable year in which the taxpayer is eligible to make the election, as determined under paragraph (c)(2)(iii) of this section, is valid unless revoked pursuant to paragraph (c)(2)(iv) of this section.

(iii) *Eligibility to make and manner of making election.* A taxpayer is eligible to make the election in the first taxable year in which—

(A) The taxpayer has an applicable financial statement described in paragraph (c)(1)(iv) of this section;

(B) The use of this applicable financial statement produces an excess of adjusted net book income over preadjustment alternative minimum taxable income, as defined in paragraph (a)(1) of this section, and

(C) The taxpayer has, as determined under section 55(a), an excess of tentative minimum tax over regular tax for the taxable year, or is liable for the environmental tax imposed by section 59A.

Thus, a taxpayer is not required to evaluate the merits of an election to use its current earnings and profits as its net book income unless the taxpayer, when using an applicable financial statement described in paragraph (c)(1)(iv) of this section, has an excess of tentative minimum tax over its regular tax or is liable for the environmental tax imposed by section 59A. The election statement must set forth the electing taxpayer's name, address and taxpayer identification number, state that the election is being made under the provisions of section 56(f)(3)(B), and state that the only financial statement of the taxpayer is a financial statement described in paragraph (c)(1)(iv) of this section. An election under this paragraph (c)(2) is effective for every taxable year in which the taxpayer does not have a financial statement described in paragraphs (c)(1)(i) through (c)(1)(iii) of this section and may be revoked only with the consent of the District Director. See paragraph (c)(6), Example 1 of this section.

(iv) *Election or revocation of election made on an amended return.* An election under paragraph (c)(2) of this section may be made by attaching the statement described in paragraph (c)(2)(iii) to an amended return for the first taxable year in which the taxpayer is eligible to make the election. An election under paragraph (c)(2) of this section that was made prior to the first taxable year in which the taxpayer was eligible to make the election, as determined under paragraph (c)(2)(iii) of this section, may be revoked by filing an amended return for the taxable year in which the election was initially made. However, an election made or revoked on an amended return will be allowed only if the amended return is filed no later than December 14, 1990.

(v) *Election by common parent of consolidated group.* The election by the common parent of a consolidated group to treat net book income as equal to current earnings and profits shall bind all members of the group. This rule shall not apply in the case of any taxpayer that first, has made the election on a return filed before August 16, 1990, second, applied the election only to those members of the group that are themselves eligible to make the election, and third, properly consolidated the adjusted net book income of the group. In order to change its election to apply to all members of the group, a taxpayer must attach a statement to an amended return for the first taxable year the taxpayer is eligible to make the election. However, an election made on an amended return under this paragraph (c)(2)(iv) will be allowed only if the amended return is filed no later than December 14, 1990. See paragraph (b)(5)(ii) of this section regarding the current earnings and profits of a consolidated group. See paragraph (d)(4)(iii) of this section for adjustments that apply when a consolidated group uses current earnings and profits to compute its net book income.

(3) *Priority among statements*—(i) *In general*. If a taxpayer has more than one financial statement described in paragraphs (c)(1)(i) through (c)(1)(iv) of this section, the taxpayer's applicable financial statement is the statement with the highest priority. Priority is determined in the following order—

(A) A financial statement described in paragraph (c)(1)(i) of this section.

(B) A certified audited statement described in paragraph (c)(1)(ii) of this section.

(C) A financial statement required to be provided to a Federal or other government regulator described in paragraph (c)(1)(iii) of this section.

(D) Any other financial statement described in paragraph (c)(1)(iv) of this section.

For example, corporation A, which uses a calendar year for both financial accounting and tax purposes, prepares a financial statement for calendar year 1987 that is provided to a state regulator and an unaudited financial statement that is provided to A's creditors. The statement provided to the state regulator is A's financial statement with the highest priority and thus is A's applicable financial statement.

(ii) *Special priority rules for use of certified audited financial statements and other financial statements*. In the case of financial statements described in paragraphs (c)(1)(ii) and (c)(1)(iv) of this section, within each of these categories the taxpayer's applicable financial statement is determined according to the following priority—

(A) A statement used for credit purposes,

(B) A statement used for disclosure to shareholders, and

(C) Any other statement used for other substantial non-tax purposes.

For example, corporation B uses a calendar year for both financial accounting and tax purposes. B prepares a financial statement for calendar year 1987 that it uses for credit purposes and prepares another financial statement for calendar year 1987 that it uses for disclosure to shareholders. Both financial statements are unaudited. The statement used for credit purposes is B's financial statement with the highest priority and thus is B's applicable financial statement.

(iii) *Priority among financial statements provided to a government regulator*. In the case of two or more financial statements described in paragraph (c)(1)(iii) of this section (relating to financial statements required to be provided to a Federal or other governmental regulator) that are of equal priority, the taxpayer's applicable financial statement is determined according to the following priority—

(A) A statement required to be provided to the Federal government or any of its agencies,

(B) A statement required to be provided to a State government or any of its agencies, and

(C) A statement required to be provided to any subdivision of a state or any agency of a subdivision.

(iv) *Statements of equal priority*—(A) *In general*. Except as provided in paragraph (c)(3)(iv)(B) and paragraph (c)(5)(i)(B) of this section, if a taxpayer has two or more financial statements of equal priority (determined under paragraphs (c)(3)(i), (c)(3)(ii) and (c)(3)(iii) of this section), the taxpayer's applicable financial statement is the statement that results in the greatest amount of adjusted net book income.

(B) *Exceptions to the general rule in paragraph* (c)(3)(iv)(A). (*1*) In the case of two or more financial statements described in paragraph (c)(1)(i) of this section (relating to financial statements required to be filed with the

SEC) that are of equal priority, a certified audited financial statement has a higher priority than an unaudited financial statement.

(*2*) In the case of two or more financial statements described in paragraph (c)(1)(iv) of this section (relating to other financial statements) that are of equal priority, a financial statement accompanied by an auditor's "review report" has a higher priority than another financial statement of otherwise equal priority. For purposes of this section, an auditor's review report is defined in the American Institute of Certified Public Accountant Professional Standards, AR section 100.32. See paragraph (c)(6), Examples and 3 of this section.

(4) *Use of financial statement for a substantal non-tax purpose.* In order to be an applicable financial statement for purposes of computing the book income adjustment, a financial statement described in paragraph (c)(1)(ii) or (c)(1)(iv) must be used by the taxpayer for credit purposes, for disclosure to shareholders, or for any other substantial non-tax purpose. A financial statement is used by a taxpayer if the taxpayer reasonably anticipates that users of the statement will rely on it for non-tax purposes. Thus, a financial statement used for the purpose of computing the book income adjustment is not an applicable financial statement even if it is provided to shareholders or creditors, unless the taxpayer reasonably anticipates that users of the statement will rely on it for non-tax purposes. See paragraph (c)(6), Examples 4, 5, 19 and 20 of this section.

(5) *Special rules*—(i) *Applicable financial statement of related corporations*—(A) *Applicable financial statement of a consolidated group.* The applicable financial statement of a consolidated group (as defined in paragraph (a)(3) of this section) is the financial statement of the common parent (within the meaning of section 1504(a)(1)) of the consolidated group that has the highest priority under the rules of paragraphs (c)(3)(i), (c)(3)(ii) and (c)(5)(i)(B) of this section. See paragraph (d)(6)(i) of this section for rules relating to adjustments to net book income of a consolidated group. See paragraph (c)(6), Example 7 of this section. See paragraph (c)(2)(iv) of this section for rules relating to the election by the common parent of a consolidated group to use current earnings and profits to compute net book income.

(B) *Special rule for statements of equal priority.* If a consolidated group has two or more financial statements of equal priority (determined under paragraphs (c)(3)(i) and (c)(3)(ii) of this section and this paragraph (c)(5)), the consolidated group's applicable financial statement is determined under either paragraph (c)(5)(i)(B) (*1*) or (*2*), whichever is applicable.

(*1*) *Two or more financial statements reporting on the same corporations.* If two or more financial statements of equal priority report on the same corporations, the consolidated group's applicable financial statement is determined under the rules of paragraph (c)(3)(iv) of this section. Thus, the financial statement that results in the greatest consolidated adjusted net book income is the consolidated group's applicable financial statement.

(*2*) *Two or more financial statements reporting on different corporations.* If two or more financial statements of equal priority report on different corporations, the consolidated group's applicable financial statement is—

(*i*) The statement that reflects the greatest amount of gross receipts attributable to members of the consolidated group, or

(*ii*) The statement that reflects the greatest amount of gross receipts (including gross receipts attributable to corporations that are not members of the consolidated group), but only if the consolidated group has financial statements of equal priority after applying the rules of paragraph (c)(5)(i)(B)(*2*)(*i*).

If after applying the rules of paragraphs (c)(5)(i)(B)(*2*) (*i*) and (*ii*) of this section, the consolidated group still has financial statements of equal priority, the rules of paragraph (c)(3)(iv) of this section apply. See paragraph (c)(6), Examples 7 and 8 of this section.

(C) *Special rule for related corporations.* If any portion of the net book income of a corporation (the "first corporation") is included on the applicable financial statement of a second corporation, but the first and second corporations are not members of the same consolidated group, the applicable financial statement of the second corporation is disregarded when determining the applicable financial statement of the first corporation. Thus, the applicable financial statement of the first corporation is the financial statement of highest priority determined under the rules of paragraph (c)(3) of this section without regard to the financial statement of the second corporation. Pursuant to paragraph (c)(1)(iv) of this section, if a separate financial statement is not prepared by the first corporation, the rules of paragraph (b)(5) (relating to current earnings and profits) apply. See paragraph (c)(6), Examples 9 and 10 of this section.

(D) *Anti-abuse rule.* The special rules of this paragraph (c)(5)(i) will not apply if the taxpayer rearranges its corporate structure or modifies its financial reporting and the principal purpose of such action is to use the special rules of this paragraph (c)(5)(i) to reduce the amount of the book income adjustment. In such cases, the District Director may, based upon all the facts and circumstances, determine the taxpayer's applicable financial statement. See paragraph (c)(6), Examples 13 and 14 of this section.

(ii) *Applicable financial statement of a foreign corporation with a United States trade or business*—(A) *In general.* The applicable financial statement of a foreign taxpayer conducting one or more trades or businesses in the United States is the financial statement prepared by any such trade or business (or attributable to more than one such trades or businesses) that has the highest priority as determined under paragraph (c)(3) of this section. See paragraph (c)(6), Example 15 of this section.

(B) *Special rules for applicable financial statement of a trade or business of a foreign taxpayer*—(*1*) *Financial statement prepared under foreign generally accepted accounting principles.* Subject to the rules of this section, a financial statement prepared by a United States trade or business using generally accepted accounting principles of a foreign country may be an applicable financial statement under this paragraph (c). See paragraph (c)(6), Example 16 of this section.

(*2*) *Financial statement denominated in United States dollars.* Except as provided in paragraph (c)(5)(ii)(D) of this section, the financial statement of a United States trade or business must be denominated in United States dollars in order to be considered the applicable financial statement of the foreign taxpayer under this paragraph (c). See paragraph (c)(6), Example 17 of this section.

(C) *Special rule for statements of equal priority.* If a foreign taxpayer has two or more financial statements of equal priority (determined under paragraphs (c)(3)(i) and (c)(3)(ii) of this section and this paragraph (c)(5)(ii)), the foreign taxpayer's applicable financial statement is determined under either paragraph (c)(5)(ii)(C) (*1*) or (*2*) of this section, whichever is applicable.

(*1*) *Two or more financial statements reporting on the same trades or businesses.* If two or more financial statements of equal priority report on the same United States trades or businesses, the applicable financial statement of the foreign taxpayer is determined under the rule of paragraph (c)(3)(iv) of this section. In applying this rule, adjusted net book income (as defined under paragraph (b)(6) of this section) shall be used. Thus, the financial statement that results in the greatest amount of adjusted net book income is the foreign taxpayer's applicable financial statement.

(*2*) *Two or more financial statements reporting on different trades or businesses.* If two or more financial statements of equal priority report on different United States trades or businesses, the foreign taxpayer's applicable financial statement is—

(*i*) The financial statement that reflects the greatest amount of gross receipts attributable to United States trades or businesses, or

(*ii*) If after applying the rules of paragraph (c)(5)(ii)(C)(*2*)(*i*) of this section, the foreign taxpayer still has financial statements of equal priority, the financial statement determined under the rules of paragraph (c)(3)(iv) of this section (using effectively connected adjusted net book income).

See paragraph (c)(6), Example 18 of this section.

(D) *Anti-abuse rules.* The special rules of this paragraph (c)(5)(ii) will not apply if a trade or business conducted in the United States by a foreign taxpayer modifies its financial reporting and the principal purpose of such action is to reduce the amount of the book income adjustment. In such cases, the District Director may, based upon all the facts and circumstances, determine the taxpayer's applicable financial statement. See paragraph (c)(6), Example 21, of this section.

(iii) *Supplement or amendment to an applicable financial statement*—(A) *Excluding a restatement of net book income.* An applicable financial statement includes any supplement or amendment thereto (excluding a restatement of net book income) for the taxable year that is prepared and used for a substantial non-tax purpose (within the meaning of paragraph (c)(4) of this section) prior to the date the taxpayer's Federal income tax return for the taxable year would be due if the time for filing were extended under section 6081. For example, a calendar year taxpayer's applicable financial statement includes any supplement or amendment prepared and used prior to September 15 of the year immediately following its taxable year. If a taxpayer files its Federal income tax return before the issuance of a supplement or amendment to the applicable financial statement and before the extended due date for filing under section 6081, the taxpayer must file an amended Federal income tax return reporting any additional tax that results from treating the supplement or amendment as part of the applicable financial statement. A supplement or amendment (excluding restatements of net book income) to an applicable financial statement after the date specified in section 6081 is disregarded for purposes of the book income adjustment.

(B) *Restatement of net book income.* If a taxpayer restates net book income in what otherwise would have been its applicable financial statement (its ''original financial statement''), referred to in this section as a ''restatement of net book income,'' prior to the date that the taxpayer's Federal income tax return for such taxable year would be due if the time for filing were extended under section 6081, then—

(*1*) If the financial statement that includes the restated net book income is of a higher priority than the original financial statement, the restated financial statement is the taxpayer's applicable financial statement.

(*2*) If the financial statement that includes the restated net book income is of equal priority to the original financial statement and—

(*i*) The restatement is attributable to an error (as described in Accounting Principles Board Opinion No. 20, paragraph 13), the restated financial statement is the taxpayer's applicable financial statement, or

(*ii*) The restatement is not attributable to an error, the original and restated financial statements will be considered of equal priority, and paragraph (c)(3)(iv) will apply. Thus, the taxpayer's applicable financial statement is the financial statement that results in the greatest amount of adjusted net book income.

See paragraph (d)(4)(iv) of this section for rules that apply to restatements occurring after the due date (including the extension under section 6081) of the return for the taxable year to which the applicable financial statement relates. See paragraph (c)(6), Examples 11 and 12 of this section.

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

Example 1. In 1987, Corporation A only has a financial statement described in paragraph (c)(1)(iv) of this section and elects to treat net book income as equal to its current earnings and profits. In 1988, A has a certified audited financial statement (as described in paragraph (c)(1)(ii) of this section). In 1989, A only has a statement described in paragraph (c)(1)(iv) of this section. In 1988, A's certified audited financial statement is its applicable financial statement. However, in 1989, A is bound by the election it made in 1987 (unless revoked with the consent of the District Director) and must treat net book income as equal to its current earnings and profits.

Example 2. Corporation B prepares two unaudited financial statements. Both statements are distributed to creditors and are used for substantial non-tax purposes. The first financial statement is accompanied by an auditor's review report while the second statement has no auditor's review report. B has no other financial statement. Pursuant to paragraph (c)(3)(iv)(B)(*2*) of this section, the financial statement accompanied by the auditor's review report is B's applicable financial statement.

Example 3. Assume the same facts as in Example (2), except the financial statement accompanied by an auditor's review report is distributed to shareholders while the other statement is distributed to creditors, and both statements are used for substantial non-tax purposes. Pursuant to paragraph (c)(3)(ii) of this section, B's applicable financial statement is the statement distributed to its creditors. Paragraph (c)(3)(iv)(B)(*2*) of this section does not apply because the two statements are not of equal priority after applying paragraphs (c)(3) (i) and (ii) of this section.

Example 4. Corporation C is a closely held corporation with two shareholders. Both shareholders participate in the business on a day-to-day basis and are aware of the financial status of the business. C prepares a financial statement that is used by C's two shareholders to calculate bonuses. The financial statement prepared by C is used for a substantial non-tax purpose.

Example 5. Corporation D prepares a financial statement that it only sends to banks with which D is neither currently doing business nor negotiating. D does not reasonably anticipate that the financial statement will be relied on by the banks for any non-tax purpose, and therefore, for purposes of computing net book income, the financial statement is not used for a substantial non-tax purpose. The result would be the same if D sent the statement to a bank whose only relationship to D is that it holds a mortgage on D's property and D's rights and obligations under the mortgage are not affected by changes in its financial condition. The result would also be the same if D sent the statement to a bank with which D is doing business, and the statement is not reasonably expected to come to the attention of the bank's employees who are responsible for D's account.

Example 6. Corporation E and its subsidiaries, F and G are a consolidated group. Certified audited financial statements are prepared by EF and by FG. Both statements are used for substantial non-tax purposes. Pursuant to paragraph (c)(5)(i)(A) of this section, the financial statement that is prepared by EF is the applicable financial statement of the consolidated group. However, pursuant to paragraph (d)(6)(i)(B) of this section, an adjustment will be required to include the adjusted net book income attributable to G. The result would be the same even if the financial statement prepared by FG is of higher priority (under the rules of paragraph (c)(3) of this section) than the statement prepared by E and F.

Example 7. Corporation H and its subsidiaries I, J, and K are a consolidated group. Certified audited financial statements are prepared by H and I and by H, J, and K. Both statements are used for substantial non-tax purposes. The financial statement prepared by H, J, and K includes the greater amount of gross receipts attributable to members of the consolidated group and thus, pursuant to paragraph (c)(5)(i)(B)(*2*)(*i*) of this section, it is the consolidated group's applicable financial statement.

Example 8. Corporation L and its subsidiary M are a consolidated group. Corporation L also owns 100 percent of N, a foreign corporation that is not part of the consolidated group. A certified audited financial statement prepared by L, M and N discloses gross receipts of $200, of which $150 is attributable to L and M, and a separate certified audited financial statement prepared by L and M discloses gross receipts of $150. Both statements are used for substantial non-tax purposes. Pursuant to paragraph (c)(5)(i)(B) of this section, the consolidated group's applicable financial statement is the statement prepared by L, M and N.

Example 9. Corporation O is 60 percent owned by corporation P and 40 percent owned by corporation Q. Both P and Q prepare financial statements that are required to be filed with the SEC reflecting their respective interests in O. O also separately prepares a certified audited financial statement, or uses a summary of its books and records for credit purposes. Under paragraph (c)(5)(i)(C), O's separate statement is its applicable financial statement.

Example 10. Assume the same facts as in Example 9 except that O does not prepare a separate financial statement or a summary of its books and records for credit purposes. Pursuant to paragraph (c)(5)(i)(C) of this section, O must treat its net book income as equal to its current earnings and profits.

Example 11. Corporation R uses a calendar year for both financial accounting and tax purposes. Initially, R issues its calendar year 1987 financial statement on March 1, 1988. R's adjusted net book income resulting from this statement is $80. This would be R's applicable financial statement for 1987, but for the restatement described in the next sentence. On September 1, 1988, R restates its 1987 financial statement to correct an error (as described in Accounting Principles Board Opinion No. 20, paragraph 13). The restated financial statement is of the same priority as the initial financial statement. The restatement results in adjusted net book income for calendar year 1987 of $50. Pursuant to paragraph (c)(5)(iii)(B)(*2*)(*i*) of this section, the restated financial statement is treated as R's 1987 applicable financial statement.

Example 12. Assume the same facts as in Example (11), except that R restates its financial statement in order to reflect a change in accounting method. Since the restatement does not result from an error, paragraph (c)(5)(iii)(B)(*2*)(*i*) of this section does not apply. Pursuant to paragraph (c)(5)(iii)(B)(*2*)(*ii*) of this section, R's 1987 applicable financial statement is the financial statement for 1987 that results in the greater amount of adjusted net book income. Thus, R's March 1, 1988 financial statement is treated as its 1987 applicable financial statement.

Example 13. Corporation S, which is not a member of an affiliated group, uses a calendar year for both financial accounting and tax purposes. S's 1987 applicable financial statement is a certified audited financial statement. On January 1, 1988, S transfers all of its assets subject to liabilities to T, a newly created subsidiary that is 100 percent owned by S. The principal purpose of the transfer is to use the special rules of paragraph (c)(5)(i) of this section to reduce the adjusted net book income of S. For calendar year 1988, T prepares and uses a certified audited financial statement. Since S's only asset is its investment in T, S does not prepare a financial statement for calendar year 1988. In addition, since S is only a holding company, T's 1988 certified audited financial statement reports the same net book income that would have been reported on a consolidated ST financial statement. If paragraph (c)(5)(i)(D) of this section does not apply, ST's 1988 applicable financial statement is the financial statement of S (the parent of the consolidated group) with the highest priority. Under paragraph (c)(1) of this section, since S does not have a financial statement in 1988, the net book income of the ST consolidated group is ordinarily deemed to equal the aggregate earnings and profits of the members of the consolidated group. However, given these facts, the District Director may determine that the 1988 certified audited financial statement of T is the 1988 applicable financial statement of the ST consolidated group.

Example 14. The facts are the same as in Example 13, except that S has owned 100 percent of T for several years prior to calendar year 1987. In addition, prior to 1987, ST prepared a consolidated certified audited financial statement. For calendar year 1987, ST does not prepare a consolidated certified audited financial statement. Instead, T prepares and uses a certified audited financial statement while S does not prepare a financial statement. The principal purpose of the change in financial reporting is to use the special rules of paragraph (c)(5)(i) of this section to reduce the adjusted net book income of the ST consolidated group. Given these facts, the District Director may determine that the 1987 certified audited financial statement of T is the 1987 applicable financial statement of the ST consolidated group.

Example 15. Corporation U is a foreign corporation incorporated in A. U is a calendar year taxpayer for both financial accounting and tax purposes. U actively conducts three real estate businesses, X, Y and Z, in the United States. In 1987, X prepares a certified audited financial statement that it provides to its United States creditor. In addition, in 1987, X, Y and Z each prepare unaudited financial statements that they provide to U for incorporation in U's worldwide financial statement. Under paragraph (c)(5)(ii)(A) of this section, U's applicable financial statement is the certified audited financial statement prepared by X. However, pursuant to paragraph (d)(7) of this section, an adjustment is required to include any of U's effectively connected net book income that is not included in X's certified audited financial statement (*i.e.*, the effectively connected net book income attributable to Y and Z).

Example 16. Corporation A is a foreign corporation incorporated in Z. A is a calendar year taxpayer for both financial accounting and tax purposes. A actively conducts a real estate business, B, in the United States. B prepares a certified audited financial statement for 1987 using the accounting principles of Z that it provides to A for incorporation into A's worldwide financial statement. In addition, B prepares a review statement for 1987 using United States generally accepted accounting principles that it provides to its United States creditors. Both the certified statement and the review statement are denominated in United States dollars. Under paragraphs (c)(5)(ii)(A) and (c)(5)(ii)(B)(*1*) of this section, the financial statement prepared under the accounting principles of Z is the applicable financial statement.

Example 17. Assume the same facts as in Example (16) except that amounts are reported on B's certified audited financial statement in the currency of Z and amounts are reported on B's review statement in United States dollars. Since the review statement is denominated in United States dollars, under paragraph (c)(5)(ii)(B)(*2*) of this section, it is the applicable financial statement.

Example 18. Corporation C is a foreign corporation incorporated in Z. C is a calendar year taxpayer for both financial accounting and tax purposes. C actively conducts two real estate businesses, D and E, in the United States. D and E each separately prepare a certified audited financial statement for 1987 that they provide to their United States creditors. D's financial statement reports gross receipts of $100. E's financial statement reports gross receipts of $200. Under paragraph (c)(5)(ii)(C)(*2*) of this section, E's certified audited financial statement is the applicable financial statement and must be adjusted under the rules of paragraph (d)(7) of this section to include effectively connected book income attributable to D.

Example 19. F is a foreign corporation incorporated in X. F is a calendar year taxpayer for both financial accounting and tax purposes. F actively conducts a banking business, G, in the United States. G has been engaged in business in the United States since 1977. For the years 1977 through 1986, G did not prepare a separate financial statement. However, each year G provided F with its books, records and other raw financial data. F used this data in preparing its worldwide financial statement. G provides F with its 1987 books and records on January 5, 1988, in accordance with its historic practice. On February 15, 1988, G prepares an unaudited financial statement for calendar year 1987 that it provides to F. The principal purpose of creating this financial statement is to reduce net book income. Under these facts, the financial statement provided by G is not intended to be reasonably relied upon by F in preparing its worldwide financial statement. Therefore, for purposes of computing net book income, G's financial statement has not been used for a substantial non-tax purpose.

Example 20. Assume the same facts as in Example 19 except that for purposes of preparing F's 1987 worldwide financial statement, G does not provide F with any raw financial data, and G only provides F with an audited financial statement that is prepared for a substantial non-tax purpose. Under these facts, the financial statement provided by G is intended to be relied upon by F in preparing its worldwide financial statement. Therefore, for purposes of computing net book income, G's financial statement has been used for a substantial non-tax purpose.

Example 21. Corporation H is a foreign corporation incorporated in I. H is a calendar year taxpayer for both financial accounting and tax purposes. H actively conducts a real estate business, J, in the United States. For the years 1976 through 1986, J prepared a certified audited financial statement using United States dollars that it provided to H. In 1987, J prepares a certified audited financial statement using the currency of I. The principal purpose of the modification of J's financial reporting is to reduce the amount of the book income adjustment. Given these facts, the District Director may determine that J's 1987 certified audited financial statement prepared in the currency of I is J's applicable financial statement for 1987, and such statement must be converted into United States dollars based upon the translation used to prepare the certified audited financial statement in the currency of I. Accordingly, the effectively connected net book income of J for 1987 is the effectively connected net book income reported on the financial statement that has been converted into United States dollars.

(d) *Adjustments to net book income*—(1) *In general.* Adjusted net book income is computed by making the adjustments described in this paragraph (d) to net book income (as defined in paragraph (b)(2) of this section). No adjustment may be made to net book income except as provided in this paragraph (d).

(2) *Definitions*—(i) *Historic practice.* For purposes of this paragraph (d), historic practice is defined as an accounting practice that—

(A) Was used consistently by the taxpayer for each of the 2 years immediately preceding its first taxable year beginning after 1986, and

(B) Was used on the financial statement that would have been the taxpayer's applicable financial statement (as determined under paragraph (c) of this section) for each of the 2 years immediately preceding its first taxable year beginning after 1986 if section 56(f), as amended by the Tax Reform Act of 1986, had been in effect.

Thus, in order for a calendar year corporation to have an historic practice in 1987, the corporation must have used the accounting practice in its 1985 and 1986 financial statements. However, to be treated as used for purposes of this paragraph, an accounting practice must have been used prior to April 23, 1987. For example, an accounting practice that is first used after April 23, 1987, in a restatement of a taxpayer's 1985 and 1986 financial statements is not the taxpayer's historic practice.

(ii) *Accounting literature.* For purposes of this paragraph (d), the term "accounting literature" means—

(A) Generally accepted accounting principles (GAAP) as defined in the American Institute of Certified Public Accountants Professional Standards, AU § 411.05, paragraphs (a) through (c), and

(B) Pronouncements by the SEC including, but not limited to, Regulations S-X, SEC Financial Reporting Releases, and SEC Staff Accounting Bulletins,

that are effective for the accounting period covered by the applicable financial statement.

(3) *Adjustments for certain taxes*—(i) *In general.* Net book income for purposes of this paragraph (d) must be adjusted to disregard (for example, by adding

back) any Federal income taxes or income, war profits, or excess profits taxes imposed by any foreign country or possession of the United States that are directly or indirectly taken into account on the taxpayer's applicable financial statement. No adjustment is made for taxes not described in the preceding sentence. Taxes directly or indirectly taken into account consist of the taxpayer's total income tax expense that includes both current and deferred income tax expense. In addition, items of income and expense, including extraordinary items that are stated net of tax, must be adjusted to disregard the taxes described in this paragraph (d)(3)(i). See paragraph (d)(4)(vii) of this section for an adjustment for certain deferred foreign taxes.

(ii) *Exception for certain foreign taxes.* Net book income is not adjusted to disregard taxes imposed by a foreign country or possession of the United States if the taxpayer does not choose to take the benefits of section 901 (relating to the foreign tax credit) with respect to these taxes for the taxable year. The rule in the preceding sentence only applies to the amount of taxes the taxpayer deducts in the current taxable year under section 164(a). See paragraph (d)(3)(iv), Example 4 of this section. Net book income also is not adjusted to disregard foreign taxes that cannot be claimed as a credit (other than by virtue of a foreign tax credit limitation). Thus, a taxpayer does not add back to net book income any taxes it is not allowed to claim as a credit against its United States income tax liability because of section 245(a)(8), 901(j), 907(b) or 908 of the Code.

(iii) *Certain valuation adjustments.* Income tax expense under paragraph (d)(3)(i) of this section does not include valuation adjustments such as the valuation adjustments related to purchase accounting described in Accounting Principles Board (APB) Opinion No. 16, paragraph 89. However, income tax expense does include the tax associated with any gain or loss on the sale or other disposition of any asset the basis of which was adjusted under paragraph 89 of Opinion 16. See paragraph (d)(3)(iv), Example 6 of this section.

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

Example 1. Corporation A has $120 of net book income. In calculating net book income, A has deducted $20 of state income tax expense and $60 of Federal income tax expense. Assuming there are no other adjustments to net book income, A's adjusted net book income is $180 ($120 of net book income + $60 of Federal income tax expense). Pursuant to paragraph (d)(3)(i) of this section, no adjustment is made for the state income tax expense.

Example 2. Assume the same facts as in Example 1, except that A also has a net extraordinary item of $40. Thus, A has net book income of $160 ($120 + $40). The $40 net extraordinary item is composed of a $70 gross extraordinary item less $30 of Federal income tax expense. Assuming there are no other adjustments to net book income, A's adjusted net book income is $250 ($160 of net book income + $60 of Federal income tax expense on book income other than the extraordinary item + $30 of Federal income tax expense on the extraordinary item).

Example 3. Assume the same facts as in Example 1, except that in calculating A's $120 of net book income, A has $50 of Federal income tax expense and $10 of foreign income tax expense. The $10 of foreign income tax expense results from a foreign branch and is composed of $7 of current foreign income tax expense and $3 of deferred foreign income tax expense. A chooses to take the benefits of the foreign tax credit under section 901 for the current taxable year. Assuming there are no other adjustments to net book income, A's adjusted net book income is $180 ($120 of net book income + $50 of Federal income tax expense + $10 of foreign income tax expense).

Example 4. Assume the same facts as in Example 3, except that A does not choose to take the benefits of the foreign tax credit in the current taxable year and instead deducts the $7 of current foreign income tax paid. Pursuant to paragraph (d)(3)(ii) of this section, net book income is not adjusted for the $7 of current foreign income tax expense. However, net book income is adjusted for the $3 of deferred foreign income tax expense. Thus, assuming there are no other adjustments to net book income, D's adjusted net book income is $173 ($120 of net book income + $50 of Federal income tax expense + $3 of deferred foreign income tax expenses).

Example 5. In 1987, corporation B only has a financial statement described in paragraph (c)(1)(iv) of this section. B elects pursuant to paragraph (c)(2) of this section to treat net book income as equal to its current earnings and profits. B's current earnings and profits in 1987 is $60, after reduction for $40 of Federal income tax (see paragraph (b)(5)(i) of this section). Pursuant to paragraph (d)(3) of this section, B must make a $40 adjustment to net book income. Thus, assuming no other adjustments to net book income, B's 1987 adjusted net book income is $100 ($60 of net book income + $40 adjustment for Federal income taxes).

Example 6. Corporation A acquires assets from corporation B in a transaction where the tax basis of B's assets will carry over to A. For financial accounting purposes, A will account for the acquisition in accordance with Accounting Principles Board (APB) Opinion No. 16. One of the assets acquired from B has an appraised value of $10,000. However, because the tax basis of B's assets will carry over to A, A's tax basis in the asset is only $7,000. Given these facts, APB Opinion No. 16, paragraph 89 requires that the asset be recorded at $10,000 less the tax effect of the difference between the appraised value and the tax basis. Assuming a 30 percent tax rate for A, the asset would be recorded at $9,100 ($10,000 appraised value—($3,000 difference between the appraised value and the tax basis × 30 percent)). If A sells the asset for $10,000, A will recognize a book gain of $900 with respect to the sale (assuming the asset is not amortized for book purposes). However, A will also have income tax expense of $900 (($10,000 sales proceeds—$7,000 tax basis) × 30 percent) with respect to the sale. Thus, A will have no net book income from the sale. Pursuant to paragraph (d)(3)(iii) of this section, A's income tax expense includes the $900 of income tax expense attributable to the effects of the valuation adjustment made in accordance with APB Opinion No. 16, paragraph 89. As a result, A's adjusted net book income with respect to its asset sale is $900 ($0 of net book income + $900 adjustment for income tax expense).

(4) *Adjustments to prevent omission or duplication*—(i) *In general.* In order to prevent omissions or duplications, net book income must be adjusted for the items described in paragraph (d)(4)(ii) through (d)(4)(vii) of this section and for such other items as approved or required by the Commissioner in published guidance. Except as provided in this paragraph (d), a taxpayer may not adjust net book income to prevent omission or duplication of items. See paragraph (d)(4)(viii), Example 1 of this section.

(ii) *Special rule for depreciating an asset below its cost.* Net book income must be adjusted to exclude depreciation or amortization expense to the extent such expense exceeds the asset's financial accounting historical cost (''excess depreciation''). However, no adjustment is required if excess depreciation has been the taxpayer's historic practice (as defined in paragraph (d)(2)(i) of this section) or if the excess depreciation is properly attributable to negative salvage value (*i.e.*, where the cost of removal or clean-up exceeds the salvage value).

(iii) *Consolidated group using current earnings and profits.* In the case of a consolidated group that uses its aggregate current earnings and profits as net book income (as determined under the rules of paragraph (b)(5)(ii) of this section), the current earnings and profits of the group is the aggregate of the current earnings and profits of each member of the group. In determining aggregate current earnings and profits, the adjustments described in § 1.1502–33 apply except for the adjustment for intercompany distributions with respect to stock and obligations or members of the group described in § 1.1502–33(c)(1) and the investment adjustment described in § 1.1502–33(c)(4)(ii)(*a*).

(iv) *Restatement of a prior year's applicable financial statement*—(A) *In general.* If a taxpayer restates an applicable financial statement and as a result, the net book income for a taxable year is restated after the last date that the taxpayer could have filed its Federal income tax return for such taxable year (if it had obtained an extension of time under section 6081 of the Code), net book income for the first successor year (as defined in paragraph (d)(4)(iv)(D) of this section) must be adjusted by that part of the cumulative effect of the restatement on net book income attributable to taxable years beginning after 1986. To the extent that the cumulative effect of the restatement on net book income includes a tax component, paragraph (d)(3) of this section may apply. See paragraph (c)(5)(iii) of this section for rules relating to the restatement of an applicable financial statement prior to the date the taxpayer's return for the taxable year would be due if the time for filing the return is extended.

(B) *Reconciliation of owner's equity in applicable financial statements.* If—

(*1*) The beginning balance of owner's equity on the taxpayer's applicable financial statement for the current taxable year is different than the ending balance of owner's equity on the taxpayer's applicable financial statement for the preceding taxable year, and

(*2*) The taxpayer is not otherwise subject to the restatement rules in paragraph (d)(4)(iv)(A) of this section,

the taxpayer will be deemed to have restated its applicable financial statement for the preceding year and paragraph (d)(4)(iv)(A) of this section will apply.

(C) *Use of different priority applicable financial statements in consecutive taxable years.* If the priority of a taxpayer's applicable financial statement (as determined under the rules of paragraph (c)(3) of this section) for the current taxable year is different than the priority of the taxpayer's applicable financial statement for the preceding taxable year, the taxpayer shall be required to adjust net book income to the extent required under the rules of either paragraph (d)(4)(iv) (A) or (B) of this section.

(D) *First successor year defined.* The "first successor year" is the first taxable year for which the taxpayer could have timely filed a return if it had obtained an extension of time under section 6081 of the Code after the restatement occurs. For example, if a calendar year corporation restates and uses its 1987 applicable financial statement between September 16, 1988 and September 15, 1989, any adjustment resulting from the restatement will be made in the taxpayer's 1988 Federal income tax return. If the restatement occurs prior to September 15, 1988, the rules of paragraph (c)(5)(iii) of this section will apply.

(E) *Exceptions.* (*1*) No adjustment is made under paragraph (d)(4)(iv)(A) of this section for a restatement prepared in accordance with APB Opinion No. 16, paragraph 53, requiring restatements of financial statements to reflect the combined operation of corporations combined in a pooling transaction.

(*2*) In order to prevent duplication of an adjustment, an adjustment otherwise required under paragraph (d)(4)(iv)(A) of this section may be decreased to take into account an adjustment previously made under the disclosure rules described in paragraph (d)(5) of the section. See paragraph (d)(4)(viii), Example 3 of this section.

(v) *Adjustment for items previously taxed as subpart F income.* Net book income does not include any item excluded from regular taxable income under section 959 if the item was included in adjusted net book income in a prior taxable year under the provisions of paragraph (b)(2)(iv) of this section and due to section 951. A taxpayer may not adjust net book income under this paragraph (d)(4)(v) to the extent any portion of the subpart F income was recognized during taxable years beginning before 1987. See Example 5 of paragraph (d)(4)(viii) of this section.

(vi) *Adjustment for poolings of interests.* In a business combination accounted for as a pooling of interests under paragraph 50 of APB Opinion 16, net book income does not include the income of a separate corporation for that part of the taxable year preceding the combination of that corporation with the taxpayer, to the extent the separate corporation included this income in its net book income for the taxable year preceding the business combination. A taxpayer may not adjust net book income under this paragraph (d)(4)(vi) to the extent the separate corporation's income is attributable to taxable years beginning before 1987.

(vii) *Adjustment for certain deferred foreign taxes.* In the case of deferred foreign taxes that were previously added back to net book income in accordance with paragraph (d)(3) of this section, a deduction is allowed in computing adjusted net book income for the taxable year in which the deferred foreign taxes are deducted under section 164(a). A taxpayer may not adjust net book income under this paragraph (d)(4)(vii) to the extent the foreign taxes were deferred during taxable years beginning before 1987.

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

Example 1. Corporation A uses a calendar year for both financial accounting and tax purposes. In 1986, A's financial statement included a $100 financial accounting loss for a plant shutdown. A could not deduct the loss on its 1986 Federal income tax return. In 1987, A deducts the loss from the 1986 plant shutdown in its 1987 Federal income tax return. As a result, A's 1987 adjusted net book income exceeds its 1987 pre-adjustment alternative minimum taxable income by $100 (an amount equal to the deduction for the 1986 plant shutdown). Pursuant to paragraph (d)(4)(i) of this section, A cannot make an adjustment to net book income.

Example 2. Corporation B uses a calendar year for both financial accounting and tax purposes. B issues its calendar year 1987 applicable financial statement on March 1, 1988. The applicable financial statement reports net book income for the calendar years 1985 through 1987 of $50, $70, and $80, respectively. On March 1, 1989 when it issues its calendar year 1988 applicable financial statement, B restates its 1985, 1986, and 1987 applicable financial statements. The restatement results from a change in accounting method that is made during calendar year 1988. After restatement, B's net book income for 1985, 1986, and 1987 is $60, $80, and $90, respectively. Based upon these facts, the cumulative effect of the restatement on B's net book income for years prior to 1988 is $30. However, since $20 of the cumulative effective is attributable to years beginning before 1987, B's 1988 net book income is increased by only $10 ($30 − $20). If the cumulative effect includes a tax adjustment, see paragraph (d)(3) of this section

Example 3. Assume the same facts for Corporation B as in Example 2, except that B's 1987 net book income of $80 is increased by $10 for purposes of B's 1987 Federal income tax return. The $10 adjustment is made pursuant to paragraph (d)(5)(iii) of this section relating to disclosure in the accountant's opinion. Specifically, the accountant's opinion on B's 1987 applicable financial statement disclosed that if D had used a certain accounting method, B's 1987 net book income would have been $90 rather than $80. The restatement of B's 1987 applicable financial statement on March 1, 1988 results entirely from B changing to the accounting method referred to in the 1987 accountant's opinion. Pursuant to paragraph (d)(4)(iv)(E)(*2*) of this section, no adjustment is made to B's 1988 net book income as a result of the restatement of B's 1987 applicable financial statement.

Example 4. Assume the same facts as in Example 1, except that when A issues its 1987 applicable financial statement it also restates the net book income reported on its 1986 financial statement to exclude the $100 loss attributable to the plant shutdown. Furthermore, the $100 loss from the plant shutdown is included in A's 1987 net book income as reported on its 1987 applicable financial statement. Pursuant to paragraph (d)(4) of this section, no adjustment is made to A's 1987 net book income as a result of the restatement of A's 1986 net book income.

Example 5. Corporation D is a domestic corporation. D owns ten percent of the issued and outstanding stock of corporation F, a foreign corporation. D and F file separate financial statements and federal income tax returns, both on a calendar-year basis. F is a controlled foreign corporation as defined in section 957. In 1987, D includes ten percent of F's subpart F income in its income under section 951. F makes no actual distributions to D in that year, and D's applicable financial statement includes the earnings of F only when actual distributions are made. See paragraph (d)(6)(i)(A) of this section. In 1987, D must adjust its net book income under paragraph (b)(2)(iv) of this section to include ten percent of F's subpart F income. In 1988, F makes an actual distribution to D which qualifies for the exclusion of section 959. D includes this actual distribution as income on its applicable financial statement for 1987. Pursuant to paragraph (d)(4)(v) of this section, D must adjust its net book income for 1988 to exclude the actual distribution from F.

(5) *Adjustments resulting from disclosure*—(i) *Adjustment for footnote disclosure or other supplementary information*—(A) *In general.* Except as described in this paragraph (d)(5)(i), net book income must be increased by any amount disclosed in a footnote or other supplementary information to the applicable financial statement if the disclosure supports a calculation of a net book income amount that would be greater than the net book income reported on the taxpayer's applicable financial statement. However, net book income will not be increased if the disclosure—

(*1*) Is specifically authorized by the accounting literature described in paragraph (d)(2)(ii) of this section, or

(*2*) Is in accordance with the taxpayer's historic practice as defined in paragraph (d)(2)(i) of this section.

See paragraph (d)(5)(v), Examples 1 and 2 of this section.

(B) *Disclosures not specifically authorized in the accounting literature.* The following footnote or other supplementary disclosure will not be considered specifically authorized in the accounting literature—

(*1*) Disclosure of what the taxpayer's net book income would have if GAAP had been used in preparing the applicable financial statement instead of tax accounting rules (or disclosure of the adjustment necessary to determine net book income on a GAAP basis), and

(*2*) Disclosure of what the taxpayer's net book income would have been if the accrual method had been used in preparing the applicable financial statement instead of the cash method (or disclosure of the adjustment necessary to determine net book income on the accrual method).

(ii) *Equity adjustments*—(A) *In general.* Except as described in this paragraph (d)(5)(ii), net book income must be increased by the amount of any equity adjustment (as defined in paragraph (d)(5)(ii)(B) of this section) included in the applicable financial statement if the equity adjustment increases owner's equity as reported on the taxpayer's applicable financial statement and the increase is attributable to the taxpayer or a member of the taxpayer's consolidated group. However, net book income will not be increased if the equity adjustment—

(*1*) Is specifically authorized by the accounting literature described in paragraph (d)(2)(ii) of this section, or

(*2*) Is in accordance with the taxpayer's historic practice as defined in paragraph (d)(2)(i) of this section.

See paragraph (d)(5)(v), Examples 3 and 4 of this section.

(*B*) *Definition of equity adjustment.* An equity adjustment is any reconciling item between beginning and ending owner's equity as reported on the taxpayer's applicable financial statement for the current taxable year. However, if properly accounted for, the following reconciling items are not considered equity adjustments and do not require adjustment under paragraph (d)(5)(ii)(A) of this section—

(*1*) Net book income,

(*2*) Non-liquidating dividend distributions, and

(*3*) Contributions to capital.

(iii) *Amounts disclosed in an accountant's opinion.* Net book income must be increased by the amount of any item disclosed in the accountant's opinion (as described in paragraphs (c)(1)(ii)(C) and (c)(1)(ii)(D) of this section) if the disclosure supports a calculation of a net book income amount that would be greater than the net book income reported on the taxpayer's applicable financial statement. However, net book income will not be increased if the disclosure is in accordance with the taxpayer's historic practice, as defined in paragraph (d)(2)(i) of this section.

(iv) *Accounting method changes that result in cumulative adjustments to the current year's applicable financial statement*—(A) *In general.* If net book income for the current taxable year includes a cumulative adjustment attributable to an accounting method change and the amount of the cumulative adjustment may be determined upon review of the applicable financial statement (including footnotes) or other supplementary disclosure, net book income for the current taxable year shall be adjusted to exclude that portion of the cumulative adjustment attributable to taxable years beginning before 1987. To the extent the cumulative adjustment is reported net of a tax, paragraph (d)(3) of this section may apply. See paragraph (d)(5)(V), Example 5 of this section. If an accounting method change results in a restatement of an applicable financial statement, paragraphs (c)(5)(iii) or (d)(4)(iv)(A) of this section may apply.

(B) *Exception.* In order to prevent duplication of an adjustment, the adjustment required under paragraph (d)(5)(iv)(A) of this section may be decreased to take into account any adjustment for the accounting method change previously made under the rules described in paragraph (d)(5) of this section (relating to adjustments resulting from disclosure).

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

Example 1. Corporation A uses a calendar year for both financial accounting and tax purposes. For calendar years 1984 through 1986, A used the cash method of accounting on its financial statement and disclosed in a footnote the net income or loss that would have resulted if the accrual method of accounting had been used. A's 1987 net book income, as reported on its 1987 applicable financial statement, is $100 and is calculated on the cash method of accounting. In addition, a footnote in A's 1987 applicable financial statement states that A's 1987 net book income would have been $30 greater had the accrual method of accounting been used. Pursuant to paragraph (d)(5)(i)(B)(*2*) of this section, A's 1987 footnote disclosure is not considered specifically authorized by the accounting literature. However, since A made such disclosure for calendar years 1985 and 1986, the 1987 disclosure is in accordance with A's historic practice, as defined in paragraph (d)(2)(i) of this section. Since A satisfies the exception described in paragraph (d)(5)(i)(A)(*2*) of this section, no adjustment is made to A's 1987 net book income for the footnote disclosure.

Example 2. Assume the same facts for corporation B as in Example (1), except that B's 1985 and 1986 financial statements did not disclose the amount of income or loss that would result if the accrual method of accounting (rather than the cash method of accounting) were used. Since B does not satisfy either of the exceptions described in paragraph (d)(5)(i)(A) of this section, B's 1987 adjusted net book income is $130 ($100 of net book income plus $30 adjustment for footnote disclosure).

Example 3. Corporation C uses a calendar year for both financial accounting and tax purposes. C's 1987 net book income, as reported on its 1987 applicable financial statement, is $200. However, as specifically authorized in FASB Statement of Standards No. 52, C's 1987 applicable financial statement also includes a $50 equity adjustment (as defined in paragraph (d)(5)(ii)(B) of this section) for foreign currency translation gains. Since the equity adjustment is specifically authorized in the accounting literature, C satisfies the exception described in paragraph (d)(5)(ii)(A)(*1*) of this section, and no adjustment is made to C's 1987 net book income for the $50 equity adjustment.

Example 4. Assume the same facts for coporation D as in Example (3), except that D's equity adjustment is for foreign currency transaction gains instead of foreign currency translation gains. Pursuant to FASB Statement of Financial Accounting Standards No. 52, foreign currency transaction gains (as compared with foreign currency translation gains) are included in the income statement rather than in equity. In addition, in 1985 and 1986, D included foreign currency transaction gains in its income statement. Since D does not satisfy either of the exceptions described in paragraph (d)(5)(ii)(A) of this section, D's 1987 adjusted net book income is $250 ($200 of net book income plus $50 equity adjustment).

Example 5. Corporation E uses a calendar year for both financial accounting and tax purposes. E's net book income for 1988 is $100. The $100 of net book income includes $30 of financial accounting loss attributable to a cumulative adjustment as of January 1, 1988, resulting from a change in E's accounting method. The $30 cumulative loss is disclosed in E's 1988 applicable financial statement. If E had made the accounting method change in calendar year 1987, the cumulative loss as of January 1, 1987 would have been $20. Based upon the above facts, E must increase net book income by $20 to disregard that portion of the cumulative adjustment attributable to years beginning before 1987. Thus, assuming no other adjustments to net book income, E's adjusted net book income for 1988 is $120 ($100 plus $20).

(6) *Adjustments applicable to related corporations*—(i) *Consolidated returns*—(A) *In general.* Pursuant to paragraphs (a)(3) and (b)(3) of this section, the book income adjustment with respect to a consolidated group (as described under paragraph (a)(3) of this section) is computed based on the consolidated adjusted net book income (as defined in paragraph (b)(3)(i) of this section). In the case of any corporation that is not included in the consolidated group, consolidated adjusted net book income of the consolidated group shall include only the sum of the dividends received from such other corporation and other amounts includible in gross income under this chapter with respect to the earnings of such other corporation. See paragraph (d)(6)(v), Example 4 of this section.

(B) *Corporations included in the consolidated Federal income tax return but excluded from the applicable financial statement*—(*1*) *In general.* Consolidated net book income reported on the applicable financial statement (as determined under paragraph (c)(5) of this section) shall be adjusted to include net book income attributable to a corporation that is included in the consolidated group but is not included in the applicable financial statement. Net book income for the corporation not included in the applicable financial statement of the consolidated group is the net book income reported on such corporation's applicable financial statement (determined under the rules of paragraph (c) of this section and adjusted under the rules of this paragraph (d)). The adjusted net book income of such corporation must be consolidated with the adjusted net book income of other members of the consolidated group and appropriate adjustments, including consolidating elimination entries, must be made.

(*2*) *Adjustments to net book income for minority interests.* Consolidated net book income must be adjusted to include income or loss allocated to minority interests in members of the consolidated group. Failure to include income or loss allocated to minority interests shall be treated as an omission of net book income. See paragraph (d)(6)(v), Example 1 of this section.

(*3*) *Corporations included in the consolidated group that are accounted for under the equity method of accounting.* No adjustment is required to consolidated net book income for income or loss of a member of the consolidated group that is reported in the applicable financial statement under the equity method of accounting (as described in APB Opinion No. 18, paragraph (6)). However, consolidated adjusted net book income (as defined in paragraph (b)(3)(i) of this section) must include 100 percent of the net book income attributable to such member. See paragraph (d)(6)(i)(B)(*2*) of this section. For example, if consolidated net book income (as defined in paragraph (b)(3)(ii) of this section) only includes 85 percent of the equity income attributable to a member of the consolidated group, an adjustment will be required to include the 15 percent of equity income excluded from consolidated net book income. In addition, to the extent the equity income reflects an adjustment for tax expense or benefit, paragraph (d)(3) may apply. See paragraph (d)(6)(v), Examples 2 and 3 of this section.

(C) *Corporations included in the applicable financial statement but excluded from the consolidated tax return.* Net book income or consolidated net book income must be adjusted to eliminate the income or loss of a corporation that is included in the applicable financial statement, but is not included in the consolidated group. When net book income attributable to a corporation that is not a member of the consolidated group is removed from the computation of net book income in the applicable financial statement, consolidating elimination entries attributable to the excluded member must also be removed.

(ii) *Adjustment under the principles of section 482.* In order to fairly allocate items relating to intercompany transactions between corporations that are owned or controlled directly or indirectly by the same interests but are not members of a consolidated group, adjustments must be made to the net book income reported on the applicable financial statement of each corporation under the principles of section 482 and the regulations thereunder (relating to allocation of income and deductions among related taxpayers). For example, assume corporation A owns 100 percent of F, a foreign subsidiary, but A and F are not members of a consolidated group. However, A and F prepare a consolidated financial statement. In adjusting A's applicable financial statement to eliminate the net book income attributable to F, A must apply the principles of section 482. If a corporation fails to make appropriate adjustments to its applicable financial statement under the rules of this paragraph (d)(6)(ii), the District Director may make such adjustments under the principles of section 482 and the regulations thereunder.

(iii) *Adjustment for dividends received from section 936 corporations*—(A) *In general.* Any dividend received from a corporation eligible for the credit provided by section 936 (relating to the possession tax credit) shall be included in adjusted net book income. For example, assume corporation A owns 100 percent of B, a section 936 corporation, and B pays a $100 dividend to A. Furthermore, assume that of the $100 dividend, $15 of withholding tax is paid to a possession of the United States, so that A only receives $85 from the dividend. Given these facts, A's adjusted net book income includes $100 with respect to the dividend from B.

(B) *Treatment as foreign taxes.* Fifty percent of any withholding tax paid to a possession of the United States with respect to dividends referred to in paragraph (d)(6)(iii)(A) of this section may be treated for purposes of the alternative minimum foreign tax credit as a tax paid to a foreign country by the corporation receiving the dividend. However, if the aggregate of these dividends exceeds the excess referred to in paragraph (a)(1) of this section, the amount treated as a tax paid to the foreign country shall not exceed 50 percent of the aggregate amount of the tax withheld multiplied by a fraction.

(*1*) The numerator of which is the excess referred to in paragraph (a)(1) of this section; and

(*2*) The denominator numerator of which is the aggregate amount of these dividends.

(C) *Treatment of taxes imposed on section 936 corporations.* Taxes paid by any corporation eligible for the credit provided under section 936 shall be treated as a withholding tax paid with respect to any dividend paid by such corporation, and thus subject to the rules of this paragraph (d)(6)(iii), but only to the extent such taxes would be treated as paid by the corporation receiving the dividend under rules similar to the rules of section 902.

(iv) *Adjustment to net book income on sale of certain investments.* If a taxpayer accounts for an investment under any method equivalent to the equity method of accounting (as described in APB Opinion No. 18, paragraph 6) and pursuant to paragraphs (b)(2)(iv) or (d)(6)(i) of this section the taxpayer excludes net book income attributable to that investment, the taxpayer must adjust its net book income in the year the investment is sold (or partially sold). The adjustment equals the amount of net book income previously excluded under paragraphs (b)(2)(iv) or (d)(6)(i)(A) of this section). See paragraph (d)(6)(v), Example 4 of this section.

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

Example 1. Corporation A and its 100 percent owned subsidiary B and its 90 percent owned subsidiary C are a consolidated group. A also owns 100 percent of D, a foreign corporation. ABC's applicable financial statement is a certified audited financial statement that includes A, B, C and D. The net book income reported on the statement excludes $10 of C's net book income that is attributable to the 10 percent minority interest in C held outside of the consolidated group. Pursuant to paragraph (d)(6)(i)(B)(*2*) of this section, net book income of the consolidated group must be adjusted to include the $10 of net book income attributable to the minority interest in C. In addition, pursuant to paragraph (d)(6)(i)(C) of this section, net book income shown on the applicable financial statement must be adjusted to eliminate the net book income attributable to D.

Example 2. Corporation E owns 100 percent of F, a finance subsidiary, and EF are a consolidated group. Since F is a finance subsidiary E's applicable financial statement accounts for F under the equity method of accounting. F also prepares a separate financial statement that is of equal or higher priority than E's applicable financial statement. In 1987, E's applicable financial statement includes $60 of equity income from F. The $60 of equity income reflects a reduction for $40 of Federal income tax expense. Thus, E's equity income from F prior to the reduction for Federal income tax expense, is $100 ($60 + $40). Since E's applicable financial statement includes E's equity income in F, F's separate financial statement is not relevant for determining the adjusted net book income of the EF consolidated group. However, pursuant to paragraphs (d)(3) and (d)(6)(i)(B)(*3*) of this section, E is required to adjust its equity income in F by the $40 of Federal income tax expense attributable to F. Thus, assuming there are no other adjustments, E's adjusted net book income with respect to F is $100.

Example 3. The facts are the same as Example (2), except that E reports its equity income in F without reduction for F's Federal income tax expense. The $40 of Federal income tax expense attributable to F is combined with E's Federal income tax expense. Assuming no other adjustments, E's adjusted net book income with respect to F is $100. Thus, E's adjusted net book income with respect to F will be the same regardless of whether E's equity income in F is reported before or after taxes.

Example 4. A, a domestic corporation, uses a calendar year for both financial accounting and tax purposes. On January 1, 1987, A purchases 100 percent of F, a foreign corporation, for $100. F does not file a Federal income tax return and A does not recognize any taxable income with respect to F under section 951 (relating to controlled foreign corporations). In its applicable financial statement, A accounts for its investment in F under the equity method of accounting. Thus, A's initial investment in F is $100. During calendar year 1987, F has $50 of net book income but makes no dividend payments to A. Under the equity method of accounting, A's net book income includes the $50 of net book income attributable to A's net book investment in F. Thus, A's investment in F is increased to $150. Pursuant to paragraph (d)(6)(i)(C) of this section, A's net book income is adjusted to eliminate the $50 of net book income attributable to F. On January 1, 1988, A sells F for $150. Since A's investment in F under the equity method of accounting is $150, A's net book income for 1988 will not include any gain on the sale of F. However, pursuant to paragraph (d)(6)(iv), A's 1988 net book income must be increased by $50, the amount of net book income previously eliminated with respect to A's investment in F. The result would be the same if instead of accounting for its investment in F under the equity method of accounting, A and F prepare a consolidated financial statement.

(7) *Adjustments for foreign taxpayers with a United States trade or business*—(i) *In general.* Pursuant to paragraph (b)(6)

of this section, the book income adjustment with respect to a foreign taxpayer with a United States trade or business is computed based on the effectively connected net book income of the foreign taxpayer (as defined in paragraph (b)(6)(ii) of this section). The net book income amount reported on the applicable financial statement of the foreign taxpayer (as determined under paragraph (c)(5)(ii) of this section) must be adjusted to—

(A) Include effectively connected net book income attributable to a trade or business conducted in the United States by the foreign taxpayer that is not reported on the applicable financial statement. Such amounts shall be determined from a financial statement (determined under paragraph (c) of this section and adjusted under the rules of this paragraph (d)) that would have qualified as an applicable financial statement of such excluded trade or business or upon effectively connected earnings and profits (if the rules of section (b)(6)(iii) of this section apply), and

(B) Exclude any amount reported on such applicable financial statement that does not qualify as effectively connected net book income.

See the example in paragraph (d)(7)(ii) of this section.

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

Example. Foreign corporation A, a calendar year taxpayer for financial accounting and tax purposes, is incorporated in X. A actively conducts two real estate businesses, B and C, in the United States. B prepares a certified audited financial statement that it provides to its United States creditor. C does not prepare a financial statement. The certified audited financial statement prepared by B is treated as A's applicable financial statement under paragraph (c)(5)(ii) of this section. B's certified audited financial statement, in addition to amounts related to the conduct of its real estate business, also reports income received from its investment in United States securities, unrelated to its conduct of business in the United States that does not qualify as effectively connected net book income. In order to determine A's effectively connected net book income from the net book income reported on the applicable financial statement, such statement must be adjusted to exclude amounts attributable to the securities. In addition, book income or loss attributable to C, to the extent effectively connected to its business in the United States, must be included in the effectively connected net book income reported on B's financial statement. Since C does not have a financial statement, C's effectively connected net book income is determined by computing its effectively connected earnings and profits under paragraph (b)(6)(iii) of this section.

(8) *Adjustment for corporations subject to subchapter F*. A corporation subject to tax under subchapter F of chapter 1 of the Code shall adjust its book income to exclude all items of income, loss or expense other than those relating to the calculation of unrelated business taxable income for purposes of section 512(a).

(e) *Special rules*—(1) *Cooperatives*. For purposes of computing the book income adjustment, net book income of a cooperative to which section 1381 applies is reduced by patronage dividends and per-unit retain allocations under section 1382(b) that are paid by the cooperative to the extent such amounts are deductible for regular income tax and general alternative minimum tax purposes under section 1382, and not otherwise taken into account in determining adjusted net book income.

(2) *Alaska Native Corporations*. In computing the net book income of an Alaska Native Corporation, cost recovery and depletion are computed using the asset basis determined under section 21(c) of the Alaska Native Claims Settlement Act (43 U.S.C. 1620(c)). In addition, net book income is reduced by expenses payable under either section 7(i) or section 7(j) of the Alaska Native Claims Settlement Act (43 U.S.C. 1606 (i) and (j)) only when deductions for such expenses are allowed for tax purposes.

(3) *Insurance companies*. In the case of an insurance company whose applicable financial statement is a statement describing in paragraph (c)(1)(iii) of this section (relating to statements provided to a government regulator), net book income for purposes of the book income adjustment is the net income or loss from operations, after reduction for dividends paid to policyholders, but without reduction for Federal income taxes.

(4) *Estimating the book income adjustment for purposes of the estimated tax liability.* See § 1.6655–7, as contained in 26 CFR part 1 revised as of April 1, 2007, for special rules for estimating the corporate alternative minimum tax book income adjustment under the annualization exception.

(5) *Effective/applicability date.* Paragraph (e)(4) of this section is applicable for taxable years beginning after September 6, 2007.

[T.D. 8307, 55 FR 33676, Aug. 17, 1990, as amended by T.D. 9347, 72 FR 44347, Aug. 7, 2007]

REGULATIONS APPLICABLE TO TAXABLE YEARS BEGINNING IN 1969 AND ENDING IN 1970

§ 1.56A–1 Imposition of tax.

(a) *In general.* Section 56(a) imposes an income tax on the items of tax preference (as defined in § 1.57–1) of all persons other than persons specifically exempt from the taxes imposed by chapter 1. The items of tax preference represent income of a person which either is not subject to current taxation by reason of temporary exclusion (such as stock options) or by reason of an acceleration of deductions (such as accelerated depreciation) or is sheltered from full taxation by reason of certain deductions (such as percentage depletion) or by reason of a special rate of tax (such as the rate of tax on corporate capital gains). The tax imposed by section 56 is in addition to the other taxes imposed by chapter 1.

(b) *Computation of tax.* The amount of such tax is 10 percent of the excess (referred to herein as ''the minimum tax base'') of—

(1) The sum of the taxpayer's items of tax preference for such year in excess of the taxpayer's minimum tax exemption (determined under § 1.58–1) for such year, over

(2) The sum of:

(i) The taxes imposed for such year under chapter 1 other than the taxes imposed by section 56 (relating to minimum tax for tax preferences), by section 531 (relating to accumulated earnings tax), or by section 541 (relating to personal holding company tax), reduced by the sum of the credits allowable under—

(*a*) Section 33 (relating to taxes of foreign countries and possessions of the United States),

(*b*) Section 37 (relating to retirement income),

(*c*) Section 38 (relating to investment credit),

(*d*) Section 40 (relating to expenses of work incentive programs), and

(*e*) Section 41 (relating to contributions to candidates for public office, and

(ii) The tax carryovers to such taxable year (as described in § 1.56A–5).

(c) *Special rule.* For purposes of paragraph (b) of this section where for any taxable year in which a tax is imposed under section 667 (relating to treatment of amounts deemed distributed by a trust in preceding years), that portion of the section 667 tax representing an increase in an earlier year's chapter 1 taxes (as recomputed), which taxes are allowed as a reduction in any such earlier year's minimum tax base, is not allowable as a reduction in the minimum tax base for the current taxable year. The remaining portion of the section 667 tax, representing the taxes imposed by section 56, section 531, and section 541, is not allowable as a reduction in the minimum tax base for any taxable year. Similarly, taxes imposed under section 614(c)(4) (relating to increase in tax with respect to aggregation of certain mineral interests) or under section 1351(d) (relating to recoveries of foreign expropriation losses) for any taxable year are not allowed as a reduction in the minimum tax base for such taxable year to the extent they represent chapter 1 taxes which are allowed as a reduction in a minimum tax base for an earlier taxable year for purposes of the computations under section 614(c)(4) or section 1351(d) or to the extent they represent an increase in the tax imposed by section 56, section 531, or section 541 in an earlier taxable year.

[T.D. 7564, 43 FR 40466, Sept. 12, 1978. Redesignated and amended by T.D. 8138, 52 FR 15309, Apr. 28, 1987]

§ 1.56A–2 Deferral of tax liability in case of certain net operating losses.

(a) *In general.* Section 56(b) provides for the deferral of liability for the minimum tax where, for the taxable year, the taxpayer has—

(1) A net operating loss for such taxable year any portion of which (under sec. 172) remains as a net operating loss carryover to a succeeding taxable year, and

(2) Items of tax preference in excess of the minimum tax exemptions (hereinafter referred to as ''excess tax preferences'').

In such a case, an amount of tax equal to the lesser of the tax imposed under section 56(a) (after allowance of the retirement income credit to the extent that such credit cannot be used against the other taxes imposed by chapter 1) or 10 percent of the amount of the net operating loss carryover described in subparagraph (1) of this paragraph is deferred. Such amount is not treated as tax imposed in such taxable year, but is treated as tax imposed in the succeeding taxable year or years in which the net operating loss is used as provided in paragraphs (b) and (c) of this section. Deferral will result in the above case regardless of the character of the tax preference items. Thus, for example, if the taxpayer has $1,030,000 of items of tax preference, including the stock option item of tax preference, and a $750,000 net operating loss available for carryover to subsequent taxable years, the amount of tax imposed for the taxable year under section 56(a) is $100,000 and $75,000 is deferred by application of section 56(b). Therefore, only $25,000 is treated as tax imposed for the taxable year. The provisions of this section are applicable in the case of a net operating loss or comparable item such as an operations loss under section 812 and an unused loss as defined in section 825(b).

(b) *Year of liability.* In any taxable year in which any portion of a net operating loss carryover attributable to the amount of excess tax preferences reduces taxable imcome (in the form of a net operating loss deduction), section 56(b)(2) treats as tax liability imposed in such taxable year an amount equal to 10 percent of such reduction. For this purpose, the portion of such net operating loss which is considered attributable to the amount of excess tax preferences is an amount equal to the lesser of such excess or the amount of the net operating loss carryover described in paragraph (a)(1) of this section. In no case, however, shall the total amount of tax imposed by reason of section 56(b) in subsequent years exceed the amount of the tax that was deferred in the loss year.

(c) *Priority of reduction.* (1) If a portion of a net operating loss is attributable to an amount of excess tax preferences, such portion is considered to reduce taxable income in succeeding taxable years only after the other portion (if any) of such net operating loss is used to reduce taxable income. Accordingly, if the amount of a net operating loss which may be carried to succeeding taxable years is reduced because of a modification required to be made pursuant to section 172(b)(2), such reduction is to be considered to be first from that portion of the net operating loss that is attributable to excess tax preferences. If a portion of a net operating loss carryover which is attributable to an amount of excess tax preferences is not used to reduce taxable income in any succeeding taxable year, no minimum tax will be imposed with respect to such portion.

(2) In the case of taxpayers with deductions attributable to foreign sources which are suspense preferences (as defined in paragraphs (c) (1)(ii) and (2)(ii) of §1.58–7), the amount of such deductions is not included in the portion of the net operating loss not attributable to excess tax preferences. The portion of the net operating loss attributable to excess tax preferences is increased by the amount of suspense preferences which are, in accordance with the provisions of §1.58–7(c), converted to actual items of tax preference (and not used against the minimum tax exemption of the loss year) in subsequent taxable years. The other portion of the net operating loss is increased by the amount of suspense preferences which reduce taxable income in subsequent taxable years but are not converted to actual items of tax preference (or are so converted but

used against the minimum tax exemption of the loss year). See §1.58–7(c)(1)(iii) example 4.

(d) *Multiple net operating loss carryovers.* In determining whether a net operating loss is used to reduce taxable income in a taxable year to which two or more net operating losses are carried, the ordering rules of section 172(b) and the regulations thereunder are to be applied. Thus, for example, the portion of a net operating loss carried over from an earlier taxable year which is attributable to an amount of excess tax preference is used to reduce taxable income in the carryover year before any portion of any other net operating loss carried over or back from a taxable year subsequent to the earlier taxable year.

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

Example 1. In 1970, A, a calendar year taxpayer, who is a single individual, has $180,000 of items of tax preference, a $150,000 net operating loss of which $100,000 may be carried forward, and no tax liability under chapter 1 without regard to the minimum tax. His minimum tax computed under section 56(a) is $15,000 (10 percent times ($180,000 minus $30,000)). Under section 56(b)(1) an amount equal to the lesser of the amount determined under section 56(a) ($15,000) or 10 percent of the net operating loss which may be carried forward ($10,000) is treated as a deferred liability. Thus, his minimum tax liability for 1970 is $5,000 ($15,000 minimum tax under section 56(a) minus $10,000 deferred tax liability under section 56(b)). If, in 1971, he has $80,000 of taxable income before the deduction for the 1970 net operating loss, his minimum tax liability is $8,000 (10 percent of the amount by which the net operating loss carryforward from 1970 reduces taxable income) plus any minimum tax liability resulting from items of tax preference arising in 1971. If, by reason of the modifications provided by section 172(b)(2), no portion of the 1970 net operating loss remains as a carryover from 1971, no further minimum tax liability will result from the items of tax preference arising in 1970.

Example 2. In 1970, A, a calendar year taxpayer who is a single individual, has $90,000 of items of tax preference, a $100,000 net operating loss available for carryover to future taxable years, no net operating loss carryovers from prior taxable years, and no tax liability under chapter 1 without regard to the minimum tax. His minimum tax computed under section 56(a) is $6,000 (10 percent times ($90,000 minus $30,000)). Under section 56(b)(1) an amount equal to the lesser of the amount determined under section 56(a) ($6,000) or 10 percent of the net operating loss subject to carryforward ($10,000) is treated as a deferred liability. Thus, A owes no minimum tax in 1970 and the entire $6,000 of minimum tax liability is deferred. Under section 56(b)(2), the portion of the net operating loss attributable to the excess tax preferences described in section 56(b)(1)(B) is $60,000.

(a) In 1971, A has $25,000 of taxable income before the deduction for the 1970 net operating loss. Thus, in 1971, A has no minimum tax liability attributable to the items of tax preference arising in 1970 since, by application of section 56(b)(3), the portion of the 1970 net operating loss carryforward not attributable to the excess described in section 56(b)(1)(B), or $40,000, is considered applied against taxable income before the remaining portion.

(b) In 1972, A has $50,000 of taxable income before the deduction for the remaining 1970 net operating loss. Thus, the first $15,000 of reduction in taxable income is considered as from the portion of the 1970 net operating loss carryforward not attributable to the excess tax preferences described in section 56(b)(1)(B) and the remaining $35,000 of reduction in taxable income is considered attributable to such excess. A's 1972 minimum tax attributable to items of tax preference arising in 1970 is, therefore, $3,500 (10 percent times $35,000).

(c) In 1973, A has $80,000 of taxable income before the deduction for the 1970 net operating loss. The remaining $25,000 of the 1970 net operating loss carryforward is used to reduce taxable income in 1973. Thus, A's 1973 minimum tax liability attributable to items of tax preference arising in 1970 is $2,500 (10 percent times $25,000).

Example 3. In 1971, M Corporation, a Western Hemisphere trade corporation (as defined in sec. 921), reporting on a calendar year basis has $20,000 of taxable income after all deductions including the Western Hemisphere trade deduction allowable under section 922 in the amount of $30,000. In 1970, M Corporation had a net operating loss of $100,000 all of which was available for carryover to 1971 and $60,000 of which was attributable to excess tax preferences. In computing the amount of the 1970 net operating loss carried over to 1972 pursuant to section 172(b), the 1971 Western Hemisphere trade corporation deduction is not taken into account. Thus, M Corporation's recomputed income under section 172(b) is $50,000 ($20,000 taxable income plus $30,000 Western Hemisphere trade corporation deduction). Pursuant to paragraph (c)(1) of this section, $20,000 of the $40,000 portion of the 1970 net operating loss not attributable to excess tax preferences is considered to reduce taxable income in 1971 and $30,000 of the $60,000 portion of the 1970 net operating loss attributable to excess tax preferences is considered reduced pursuant to section 172(b)(2). Thus, M Corporation has no 1971 minimum tax attributable to items of tax preference arising in 1970. Of the $50,000 remaining of the 1970 net operating loss, $30,000 is attributable to excess tax preference.

Example 4. In 1972, A, a calendar year taxpayer who is a single individual, has $25,000 of taxable income resulting from $50,000 of net long-term capital gains. In 1971, A had a net operating loss of $100,000 all of which is available to carryover to 1972 and $60,000 of which is attributable to excess tax preferences. By application of section 172(b) only $50,000 of the 1971 net operating loss is carried over to 1973. Pursuant to paragraph (c) of this section, $25,000 of the $40,000 portion of the 1971 net operating loss not attributable to excess tax preferences is considered to reduce taxable income in 1972. Of the $50,000 remaining of the 1971 net operating loss, $15,000 is not attributable to excess tax preferences and $35,000 is attributable to excess tax preferences. Thus, the $25,000 section 1202 deduction, in effect, reduces the portion of the 1971 net operating loss attributable to excess tax preferences. Because a net operating loss carryover is reduced to the extent of any section 1202 deduction, section 1202 deductions do not normally produce a tax benefit in such circumstances and, pursuant to §1.57–4, would not be treated as items of tax preference. However, in this case, to the extent the portion of the 1971 net operating loss carryover attributable to excess tax preferences is reduced by reason of the section 1202 deduction, such deduction does result in a tax benefit to the taxpayer and is, therefore, treated as an item of tax preference in 1971. See §1.57–4(b)(2).

[T.D. 7564, 43 FR 40467, Sept. 12, 1978. Redesignated by T.D. 8138, 52 FR 15309, Apr. 28, 1987]

§ 1.56A–3 Effective date.

(a) *In general.* The minimum tax is effective for taxable years ending after December 31, 1969.

(b) *Taxable year beginning in 1969 and ending in 1970.* In the case of a taxable year beginning in 1969 and ending in 1970, the amount of the minimum tax shall be an amount equal to the amount determined under section 56 multiplied by the following fraction:

Number of days in the taxable year ending after December 31, 1969 ÷ Number of days in the entire taxable year.

Where, by reason of section 56(b) and §1.56A–2, tax initially imposed in a 1969–70 fiscal year is deferred until a subsequent taxable year or years, the amount of such tax liability in any subsequent taxable year is determined by application of the above fraction. Section 21, relating to computation of tax in years where there is a change in rates, is not applicable to the initial imposition of the minimum tax for tax preferences. The applications of this paragraph may be illustrated by the following example:

Example. The taxpayer uses a June 30 fiscal year. For fiscal 1969–1970 the taxpayer has $180,000 of items of tax preference and a $50,000 net operating loss. In fiscal year 1970–1971, the taxpayer uses the full net operating loss carryover from 1969–1970 to reduce his taxable income by $50,000. Thus, without regard to the proration rules applicable under this section, the taxpayer's minimum tax liability for items of tax preference arising in 1969–1970 is $15,000, *i.e.*, 10 percent × ($180,000 − $30,000), of which $5,000, *i.e.*, 10 percent × $50,000, is deferred until 1970–1971 under the principles of section 56(b) and section 1.56A–2. By application of the above formula the taxpayer's actual minimum tax liability is $4,958.90 in 1969–1970 and $2,479.45 in 1970–1971 determined as follows:

1969–1970: 181/365 × $10,000
1970–1971: 181/365 × $5,000

[T.D. 7564, 43 FR 40468, Sept. 12, 1978. Redesignated and amended by T.D. 8138, 52 FR 15309, Apr. 28, 1987]

§ 1.56A–4 Certain taxpayers.

For application of the minimum tax in the case of estates and trusts, electing small business corporations, common trust funds, regulated investment companies, real estate investment trusts, and partnerships, see §§1.58–2 through 1.58–6.

[T.D. 7564, 43 FR 40468, Sept. 12, 1978. Redesignated by T.D. 8138, 52 FR 15309, Apr. 28, 1987]

§ 1.56A–5 Tax carryovers.

(a) *In general.* Section 56(c) provides a 7–year carryover of the excess of the taxes described in paragraph (1) of such section imposed during the taxable year over the items of tax preference described in paragraph (2) of such section for such taxable year for the purpose of reducing the amount subject to tax under section 56(a) in subsequent taxable years.

(b) *Computation of amount of carryover.* The amount of tax carryover described in section 56(c) is the excess (if any) of—

(1) The taxes imposed for the taxable year under chapter 1 other than taxes

imposed by section 56 (relating to minimum tax for tax preferences), by section 531 (relating to accumulated earnings tax), or by section 541 (relating to personal holding company tax), reduced by the sum of the credits allowable under—

(i) Section 33 (relating to taxes of foreign countries and possessions of the United States),

(ii) Section 37 (relating to retirement income,

(iii) Section 38 (relating to investment credit),

(iv) Section 40 (relating to expenses of work incentive programs), and

(v) Section 41 (relating to contributions to candidates for public office), over

(2) The sum of the taxpayer's items of tax preference for such year in excess of the taxpayer's minimum tax exemption (determined under §1.58–1) for such year.

For purposes of section 56(c) and this section, taxes imposed in a taxable year ending on or before December 31, 1969, are not included in the taxes described in subparagraph (1) of this paragraph. In addition, the rules of paragraph (c) of §1.56A–1 are applicable in determining the taxable year for which taxes are imposed under chapter 1 for purposes of paragraph (a)(1) of this section.

(c) *Operation of carryover*. Tax carryovers attributable to the taxable year shall be carried over to each of the 7 succeeding taxable years as follows:

(1) To the first such succeeding taxable year to reduce in the manner described in paragraph (d) of this section the amount subject to tax under section 56(a) for such first succeeding taxable year and

(2) To the extent such amount is not used as a reduction in the amount subject to tax under section 56(a) for such taxable year, such amount (if any) is carried over to each of the succeeding 6 taxable years but only to the extent such amount is not used to reduce the amount subject to tax under section 56(a) in taxable years intervening between the taxable year to which such amount is attributable and the taxable year to which such amount may otherwise be carried over.

(d) *Priority of reduction*. Where tax carryovers attributable to two or more taxable years are carried over to a subsequent taxable year such amounts attributable to the earliest taxable year shall be used to reduce the amount subject to tax under section 56(a) for such subsequent taxable year before any such amounts attributable to a later taxable year.

(e) *Special rules*—(1) *Periods of less than 12 months*. A fractional part of a year which is a taxable year under section 441(b) or 7701(a)(23) is a taxable year for purposes of section 56(c) and this section.

(2) *Electing small business corporations*. A taxable year for which a corporation is an electing small business corporation (as defined in section 1371(b)) shall be counted as a taxable year for purposes of determining the taxable years to which amounts which are available as a carryover under paragraph (a) of this section may be carried whether or not such carryovers arose in a year in which an election was in effect.

(3) *Husband and wife*—(i) *From joint to separate return*. If a joint return is filed by a husband and wife in a taxable year or years to which a tax carryover is attributable but separate returns are filed in any subsequent taxable year to which such carryover may be carried over to reduce the amount subject to tax under section 56(a), such carryover described in paragraph (b) of this section shall be allocated between husband and wife for purposes of reducing the amount subject to tax under section 56(a) for such subsequent taxable year in accordance with the principles of §1.172–7(d).

(ii) *From separate to joint return*. If separate returns are filed by a husband and wife in a taxable year or years in which a tax carryover is attributable but a joint return is filed in any subsequent taxable year to which such carryover may be carried over to reduce the amount subject to tax under section 56(a), such carryover shall be aggregated for purposes of reducing the amount subject to tax under section 56(a), for such subsequent taxable year.

(4) *Estates and trusts*. In the case of the termination of an estate or trust, tax carryovers attributable to the estate or trust shall not be allowed to

the beneficiaries succeeding to the property of the estate or trust.

(5) *Corporate acquisitions.* In the case of a transaction to which section 381(a) applies, the acquiring corporation shall succeed to and take into account, as of the close of the date transfer the tax carryovers attributable to the distributor or distribution or transferor corporation. The portion of such carryovers which may be taken into account under paragraph (b)(2)(ii) of §1.56A–1 for any taxable year shall not exceed the excess of (i) the sum of the items of tax preference for such year resulting from the continuation of the business in which the distributor or transferor corporation was engaged at the time of such transaction and the items of tax preference not related to the continuation of such business which are directly attributable to the assets acquired from the distributor or transferor corporation over (ii) an amount which bears the same ratio to the acquiring corporation's minimum tax exemption for such year as the items of tax preference described in subdivision (i) of this subparagraph bears to all of the acquiring corporation's items of tax preference for such year. This item shall be taken into account by the acquiring corporation subject to the rules in section 381(b) and the regulations thereunder.

(f) *Suspense preferences.* Where an item of tax preference which is a suspense preference (as defined in §1.58–7) arises in a taxable year in which tax carryovers may be used to reduce the minimum tax base (or in which such carryovers arise the minimum tax liability for that year and the tax carryovers to subsequent taxable years shall be recomputed upon the conversion of the suspense preference in a subsequent year. In lieu of the above, in all cases, since there is no difference in tax consequence, the recomputation may be accomplished by recomputing the minimum tax liability of the taxable year in which the suspense preference arose without reduction of the minimum tax base for the tax carryovers which have been used as a reduction in the minimum tax base in intervening taxable years. If such method is used, the minimum tax liability of the intervening year is not recomputed and any tax carryovers carried from the taxable year in which the suspense preference arose which remain as a carryover in the year of conversion are reduced, in the priority provided in paragraph (d) of this section, to the extent used to reduce an increase in the minimum tax base for the earlier year resulting from the conversion of the suspense preference.

(g) *Taxes imposed in a taxable year beginning in 1969 and ending in 1970.* In the case of a taxable year beginning in 1969 and ending in 1970 the amount of the carryover determined under paragraph (b) of this section is reduced to an amount equal to the amount of such carryover (without regard to this paragraph) multiplied by the following fraction:

Number of days in taxable year ending after December 31, 1969 ÷ Number of days in the entire taxable year.

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

Example 1. A is a single individual who uses a June 30 fiscal year. For fiscal 1968–1969, A had income tax liability under chapter 1 in the amount of $100,000. For fiscal 1969–1970, A had items of tax preference in the amount of $212,500 and income tax liability under chapter 1 (other than taxes imposed under sections 56, 531, and 541) of $365,000.

(a) The chapter 1 tax attributable to fiscal 1968–1969 is not available as a carryover under section 56(c) to reduce the amount subject to tax under section 56(a) since this tax arose in a taxable year ending on or before December 31, 1969.

(b) A portion of the excess of chapter 1 tax over the amount subject to tax under section 56(a) attributable to fiscal year 1969–1970 is available as a carryover as provided in section 56(c) to reduce the amount subject to tax under section 56(a). The amount of this carryover is $91,000 computed as follows:

1. Carryover under paragraph (b) of this section:	
Chapter 1 taxes	$365,000
Items of tax preference in excess of exemption	182,500
Total	182,500
2. Reduction pursuant to paragraph (g) of this section:	

$182 / 365 \times \$182{,}500 = \$91{,}000$

Example 2. A is a calendar year taxpayer who is a single individual. In 1972, A had chapter 1 income tax liability (other than taxes imposed under sections 56, 531, and 541) of $200,000 and $50,000 of items of tax preference. In 1973, A had chapter 1 income tax liability (other than taxes imposed under sections 56, 531, and 541) of $120,000 and $40,000 of items of tax preference. In 1974, A had $400,000 of items of tax preference and no liability for tax under chapter 1 other than under section 56(a). Under section 56(c), the excess of the taxes described in paragraph (1) of that section arising in an earlier taxable year not used to reduce the amount subject to tax under section 56(a) for such taxable year can be carried over as provided in section 56(c) to reduce the amount subject to tax under section 56(a).

(a) The amount of the carryover from 1972 is $180,000 computed as follows:

Carryover under paragraph (b) of this section:	
Chapter 1 taxes	$200,000
Items of tax preference in excess of exemption	20,000
Total	180,000

(b) The amount of the carryover from 1973 is $110,000 computed as follows:

Carryover under paragraph (b) of this section:	
Chapter 1 taxes	$120,000
Items of tax preference in excess of exemption	10,000
Total	110,000

(c) For 1974, the excess of taxes in the preceding taxable years is used to reduce the amount subject to tax under section 56(a). The amount of carryover attributable to excess taxes arising in 1972 is used before such excess arising in 1973. The amount of tax under section 56(a) is $8,000 computed as follows:

1974 tax preferences	$400,000
Less exemption	30,000
	370,000
Less 1972 carryover	180,000
	190,000
Less 1973 carryover	110,000
1974 minimum tax base	80,000
1974 minimum tax ($80,000 × 10%)	8,000

Example 3. The facts are the same as in example 2 except that in 1974 A had $300,000 of items of tax preference. The amount of the carryover for taxable years after 1974 is computed as follows:

1974 tax preferences	$300,000
Less exemption	30,000
	270,000
Less 1972 carryover	180,000
	90,000
Less 1973 carryover	90,000
Minimum tax base	0
1973 carryover	110,000
Amount used in 1974	90,000
Amount available for taxable years after 1974	20,000

The $20,000 remaining of the 1973 carryover is available to reduce the amount subject to tax under section 56(a) in 1975 or other future taxable years as provided in section 56(c).

Example 4. M Corporation is a calendar year taxpayer. N Corporation uses a June 30 fiscal year. For the fiscal year 1970–1971, N Corporation had excess chapter 1 tax liability as described in paragraph (a) of this section in the amount of $75,000. On January 1, 1972, M Corporation acquired N Corporation in a reorganization described in section 368(a)(1)(A). N Corporation does not use any of such excess chapter 1 tax liability to reduce the amount subject to tax under section 56(a) for the short taxable year beginning on July 1, 1971, and ending on December 31, 1971. Thus, the excess chapter 1 tax liability is available to M Corporation as a carryover under paragraph (a) of this section to reduce the amount subject to tax for the next 6 succeeding taxable years beginning with taxable year 1972 as provided in this section. In applying the carryover to 1972 and succeeding taxable years, the carryover of N Corporation subject to the limitation of §1.56A–5(e)(4) is combined with any carryovers originating with M Corporation in 1970.

[T.D. 7564, 43 FR 40468, Sept. 12, 1978. Redesignated and amended by T.D. 8138, 52 FR 15309, Apr. 28, 1987]

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[T.D. 8340, 56 FR 11083, Mar. 15, 1991, as amended by T.D. 8454, 57 FR 60476, Dec. 21, 1992]

§ 1.56(g)–1 Adjusted current earnings.

(a) *Adjustment for adjusted current earnings*—(1) *Positive adjustment.* For taxable years beginning after December 31, 1989, the alternative minimum taxable income of any taxpayer described in paragraph (a)(4) of this section is increased by the adjustment for adjusted current earnings. The adjustment for adjusted current earnings is 75 percent of the excess, if any, of—

(i) The adjusted current earnings (as defined in paragraph (a)(6)(ii) of this section) of the taxpayer for the taxable year over.

(ii) The pre-adjustment alternative minimum taxable income (as defined in paragraph (a)(6)(i) of this section) of the taxpayer for the taxable year.

(2) *Negative adjustment*—(i) *In general.* For taxable years beginning after December 31, 1989, the alternative minimum taxable income of any taxpayer is decreased, subject to the limitation of paragraph (a)(2)(ii) of this section, by 75 percent of the excess, if any, of pre-adjustment alternative minimum taxable income (as defined in paragraph (a)(6)(i) of this section), over adjusted current earnings (as defined in paragraph (a)(6)(ii) of this section).

(ii) *Limitation on negative adjustments.* The amount of the negative adjustment for any taxable year is limited to the excess, if any, of—

(A) The aggregate increases in alternative minimum taxable income in prior years under paragraph (a)(1) of this section over

(B) The aggregate decreases in alternative minimum taxable income in prior years under this paragraph (a)(2).

Any excess of pre-adjustment alternative minimum taxable income over adjusted current earnings that is not allowed as a negative adjustment for the taxable year because of the limitation in this paragraph (a)(2)(ii) is not applied to reduce any positive adjustment in any other taxable year.

(iii) *Example.* The following example illustrates the provisions of this paragraph (a)(2):

(A) Corporation P is a calendar-year taxpayer and has pre-adjustment alternative minimum taxable income and adjusted current earnings in the following amounts for 1990 through 1993:

Year	Pre-adjustment alternative minimum taxable income	Adjusted current earnings
1990	$800,000	$700,000
1991	600,000	900,000
1992	500,000	400,000
1993	500,000	100,000

(B) Under these facts, corporation P has the following positive and negative adjustments for adjusted current earnings:

Year	Negative adjustment	Positive adjustment
1990	0	0
1991	0	$225,000

Year	Negative adjustment	Positive adjustment
1992	$75,000	0
1993	150,000	0

(C) In 1990, P has a potential negative adjustment (before the cumulative limitation) of $75,000 (75 percent of the $100,000 excess of pre-adjustment alternative minimum taxable income over adjusted current earnings). Nonetheless, P is not permitted a negative adjustment because P had no prior increases in its alternative minimum taxable income due to an adjustment for adjusted current earnings.

(D) In 1991, P has a positive adjustment of $225,000 (75 percent of the $300,000 excess of adjusted current earnings over pre-adjustment alternative minimum taxable income). P is not allowed to use the prior year's excess of pre-adjustment alternative minimum taxable income over adjusted current earnings to reduce its 1991 positive adjustment.

(E) In 1992, P is permitted a negative adjustment of $75,000, the full amount of 75 percent of the $100,000 excess of pre-adjustment alternative minimum taxable income over adjusted current earnings for the taxable year. This is because P's prior cumulative increases in alternative minimum taxable income due to the positive adjustments for adjusted current earnings exceed the negative adjustment for the year.

(F) In 1993, P has a potential negative adjustment (before the cumulative limitation) of $300,000 (75 percent of the $400,000 excess of pre-adjustment alternative minimum taxable income over adjusted current earnings). P's net cumulative increases in alternative minimum taxable income due to the adjustment for adjusted current earnings are $150,000 ($225,000 increase in 1991, less $75,000 decrease in 1992). Thus, P's negative adjustment in 1993 is limited to $150,000. P may not use the remaining portion ($150,000) of the negative adjustment for 1993 to reduce positive adjustments in other taxable years.

(3) *Negative amounts.* In determining whether an excess exists under paragraph (a)(1) or (a)(2) of this section, a positive amount exceeds a negative amount by the sum of the absolute numbers, and a smaller negative amount exceeds a larger negative amount by the difference between the absolute numbers. Thus, for example, a positive amount of adjusted current earnings of $30 exceeds a negative amount (or loss) of pre-adjustment AMTI of $10 by the sum of the absolute numbers, or $40 (30 + 10). Accordingly, the adjustment for adjusted current earnings would be 75 percent of $40, or $30. In contrast, a negative amount of adjusted current earnings of $10 exceeds a negative amount (or loss) of pre-adjustment alternative minimum taxable income of $30 by the difference between the absolute numbers, or $20 (30 − 10). Accordingly, the adjustment for adjusted current earnings would be 75 percent of $20, or $15.

(4) *Taxpayers subject to adjustment for adjusted current earnings.* The adjustment for adjusted current earnings applies to any corporation other than—

(i) An S corporation as defined in section 1361,

(ii) A regulated investment company as defined in section 851,

(iii) A real estate investment trust as defined in section 856, or

(iv) A real estate mortgage investment conduit as defined in section 860A.

(5) *General rule for applying Internal Revenue Code provisions in determining adjusted current earnings*—(i) *In general.* Except as otherwise provided by regulations or other guidance issued by the Internal Revenue Service, all Internal Revenue Code provisions that apply in determining the regular taxable income of a taxpayer also apply in determining adjusted current earnings. For example, the rules of part V of subchapter P (relating to original issue discount and similar matters) of the Code apply in determining the amount (and the timing) of any interest income included in adjusted current earnings under this section. In applying Code provisions, however, the adjustments of section 56(g) and this section are also taken into account. For example, in applying the capitalization provisions of section 263A, the amount of depreciation to be capitalized is based on the amount of depreciation allowed in computing adjusted current earnings.

(ii) *Example.* The following example illustrates the provisions of this paragraph (a)(5):

(A) Corporation N is a calendar year manufacturer of golf clubs. N places new manufacturing equipment in service in 1990. The regular tax depreciation allowable for this equipment is $80,000; the pre-adjustment alternative minimum taxable income depreciation is $60,000; and the adjusted current earnings depreciation is $40,000. All of the golf clubs N produces in 1990 are unsold and are in ending inventory.

(B) Pursuant to section 263A and §1.263A–1(e)(3)(ii)(I), N must capitalize the depreciation allowed for the year for the new manufacturing equipment in the ending inventory of golf clubs. Thus, when N sells the golf clubs (or is deemed to have sold them under its normal method of accounting), the cost of goods sold attributable to the capitalized depreciation will be $80,000 in computing regular taxable income; $60,000 in computing pre-adjustment alternative minimum taxable income; and $40,000 in computing adjusted current earnings.

(6) *Definitions*. The following terms have the following meanings for purpose of this section.

(i) *Pre-adjustment alternative minimum taxable income*. Pre-adjustment alternative minimum taxable income is the alternative minimum taxable income of the taxpayer for the taxable year, determined under section 55(b)(2), but without the adjustment for adjusted current earnings under section 56(g) and this section, without the alternative tax net operating loss deduction under section 56(a)(4), and without the alternative tax energy preference deduction under section 56(h).

(ii) *Adjusted current earnings*. Adjusted current earnings is the pre-adjustment alternative minimum taxable income of the taxpayer for the taxable year, adjusted as provided in section 56(g) and this section. To the extent an amount is included (or deducted) in computing pre-adjustment alternative minimum taxable income for the taxable year (whether because an adjustment is made under section 56 or 58, because of a tax preference item under section 57, or because the item is reflected in taxable income), that amount is not again included (or deducted) in computing adjusted current earnings for the taxable year.

(iii) *Earnings and profits*. Earnings and profits means current earnings and profits within the meaning of section 316(a)(2), that is, earnings and profits for the taxable year computed as of the close of the taxable year of the corporation without diminution by reason of any distributions made during the taxable year.

(7) *Application to foreign corporations*. See paragraph (m) of this section for rules relating to the application of this section to foreign corporations.

(b) *Depreciation allowed*. The depreciation deduction allowed in computing adjusted current earnings is determined under the rules of this paragraph (b). Generally, the rules for computing the adjusted current earnings depreciation deduction differ depending on the taxable year in which the property is placed in service and the method used in computing the depreciation deduction for taxable income purposes. See §1.168(i)–1(k) for an election to use general asset accounts.

(1) *Property placed in service after 1989*. The depreciation deduction for property placed in service in a taxable year beginning after December 31, 1989, is the amount determined by using the alternative depreciation system of section 168(g). This paragraph (b)(1) does not apply to property to which paragraph (b)(4) of this section applies (relating to certain property described in sections 168 (f)(1) through (f)(4)).

(2) *Property subject to new ACRS*—(i) *In general*. This paragraph (b)(2) provides the rules for computing the depreciation deduction for property to which the amendments made by section 201 of the Tax Reform Act of 1986 (new ACRS) apply (generally property placed in service after December 31, 1986), and that is placed in service in a taxable year beginning before January 1, 1990. This paragraph (b)(2) does not apply to property described in paragraph (b)(4) of this section (relating to certain property described in sections 168 (f)(1) through (f)(4)) or to property described in paragraph (b)(5)(i) of this section (relating to certain churning transactions described in section 168(f)(5)).

(ii) *Rules for computing the depreciation deduction*. The depreciation deduction for property described in this paragraph (b)(2) is the amount determined by using—

(A) The adjusted basis of the property as determined in computing alternative minimum taxable income as of the close of the last taxable year beginning before January 1, 1990,

(B) The straight-line method, and

(C) The recovery period that consists of the remainder of the recovery period applicable to the property under the alternative depreciation system of section 168(g).

Thus, the recovery period begins on the first day of the first taxable year beginning after December 31, 1989, and ends on the last day of the recovery period that would have applied had the recovery period for the property originally been determined under section 168(g). In determining the recovery period that would have applied, the property is deemed placed in service on the date it was considered placed in service under the depreciation convention that would have applied to the property under section 168(d).

(iii) *Example.* The following example illustrates the provisions of this paragraph (b)(2).

Example. Corporation X, a calendar-year taxpayer, purchases and places in service on August 1, 1987, computer-based telephone central office switching equipment. This is the only item of depreciable property X places in service during 1987. Thus, the applicable convention under section 168(d) is the half-year convention. As of December 31, 1989, the adjusted basis of the property used in computing alternative minimum taxable income is $42,000. The recovery period that would have applied to the property under section 168(g)(2) is 9.5 years (from July 1, 1987 to December 31, 1996). Thus, the recovery period for computing adjusted current earnings under section 56(g)(4)(A)(ii) and this paragraph (b)(2) begins on January 1, 1990, and ends on December 31, 1996. X's 1990 depreciation deduction for computing adjusted current earnings is $6,000, determined under the straight-line method by dividing $42,000 (adjusted basis) by 7 (recovery period).

(3) *Property subject to original ACRS*—(i) *In general.* This paragraph (b)(3) provides the rules for computing the depreciation deduction for property to which section 168 as in effect on the day before the date of enactment of the Tax Reform Act of 1986 (original ACRS) applies and that is placed in service in a taxable year beginning before January 1, 1990 (generally property that was placed in service after December 31, 1980 and before January 1, 1987). In determining whether original ACRS applies to property, the fact that the unadjusted basis of the property is reduced or eliminated under section 168(d)(4)(A)(i) of original ACRS is not taken into account. This paragraph (b)(3) does not apply to property described in paragraph (b)(4) or (b)(5)(i) of this section (relating to certain section 168(f) property).

(ii) *Rules for computing the depreciation deduction.* The depreciation deduction for property described in this paragraph (b)(3) is the amount determined by using—

(A) The adjusted basis of the property as determined in computing taxable income as of the close of the last taxable year beginning before January 1, 1990,

(B) The straight-line method, and

(C) The recovery period that consists of the remainder of the recovery period applicable to the property under the alternative depreciation system of section 168(g). Thus, the recovery period begins on the first day of the first taxable year beginning after December 31, 1989, and ends on the last day of the recovery period that would have applied had the recovery period for the property originally been determined under section 168(g)(2). In determining the recovery period that would have applied, the property is deemed placed in service on the date it was considered placed in service under the depreciation convention that would have applied to the property under section 168(d) (without regard to section 168(d)(3)).

(iii) *Example.* The following example illustrates the provisions of this paragraph (b)(3).

Example. Corporation Y, a calendar-year taxpayer, purchases and places in service on December 1, 1986, computer-based telephone central office switching equipment. The depreciation convention that would have applied to this property under section 168(d) (without regard to section 168(d)(3)) is the half-year convention. As of December 31, 1989, the adjusted basis of the property used in computing taxable income is $21,000. The recovery period for the property under section 168(g)(2) is 9.5 years (from July 1, 1986 to December 31, 1995). Thus, the recovery period for computing adjusted current earnings under section 56(g)(4)(A)(iii) and this paragraph (b)(3) begins on January 1, 1990, and ends on December 31, 1995. Y's 1990 depreciation deduction for computing adjusted current earnings is $3,500, determined under the straight-line method by dividing $21,000 (adjusted basis) by 6 (recovery period).

(4) *Special rule for certain section 168(f) property.* The depreciation or amortization deduction for property described in section 168(f) (1) through (4) is determined in the same manner as used in

computing taxable income, without regard to when the property is placed in service.

(5) *Certain property not subject to ACRS.* The depreciation or amortization deduction for property not described in paragraphs (b) (1) through (4) of this section is determined in the same manner as used in computing taxable income. Thus, this paragraph (b)(5) applies to—

(i) Property placed in service after December 31, 1980, in a taxable year beginning before January 1, 1990, and that is excluded from the application of original ACRS or new ACRS by section 168(e)(4) of original ACRS or section 168(f)(5)(A)(i) of new ACRS, and

(ii) Property placed in service before January 1, 1981.

(c) *Inclusion in adjusted current earnings of items included in earnings and profits*—(1) *In general.* Except as otherwise provided in paragraph (c)(4) of this section, adjusted current earnings includes all income items that are permanently excluded from (*i.e.*, not taken into account in determining) pre-adjustment alternative minimum taxable income but that are taken into account in determining earnings and profits. An income item is considered taken into account in determining pre-adjustment alternative minimum taxable income without regard to the timing of its inclusion. Thus, this paragraph (c)(1) does not apply to any income item that is, has been, or will be included in pre-adjustment alternative minimum taxable income. For example, a taxpayer eligible to use the completed contract method of accounting for long-term construction contracts does not take income (or expenses) into account in determining pre-adjustment alternative minimum taxable income for taxable years before the taxable year the contract is completed. The taxpayer is required under section 312(n)(6) to include income (and expenses) in earnings and profits throughout the term of the contract under the percentage of completion method. This paragraph (c)(1) does not require the income on the contract to be included in adjusted current earnings, however, because the income will be taken into account in the taxable year the contract is completed and therefore is considered to be taken into account in determining pre-adjustment alternative minimum taxable income.

(2) *Certain amounts not taken into account in determining whether an item is permanently excluded.* The fact that proceeds from an income item may eventually be reflected in pre-adjustment alternative minimum taxable income of another taxpayer on the liquidation or disposal of a business, or similar circumstances, is not taken into account in determining whether the item is permanently excluded from pre-adjustment alternative minimum taxable income. Thus, for example, a corporation's adjusted current earnings include interest excluded from pre-adjustment alternative minimum taxable income under section 103 even though the interest might eventually be reflected in the pre-adjustment alternative minimum taxable income of a corporate shareholder as gain on the liquidation of the corporation.

(3) *Allowance of offsetting deductions.* In determining adjusted current earnings under this paragraph (c), a deduction is allowed for all items that relate to income required to be included in adjusted current earnings under this paragraph (c) and that would be deductible in computing pre-adjustment alternative minimum taxable income if the income items to which the items of deduction relate were included in pre-adjustment alternative minimum taxable income for any taxable year. For example, deductions disallowed under section 265(a)(2) for the costs of carrying tax-exempt obligations, the interest on which is excluded from pre-adjustment alternative minimum taxable income under section 103 but is included in adjusted current earnings under this paragraph (c), are generally allowed as deductions in computing adjusted current earnings. Amounts deductible under this paragraph (c)(3) are taken into account using the taxpayer's method of accounting and are subject to any provisions or limitations of the Code that would have applied if the amounts had been deductible in determining pre-adjustment alternative minimum taxable income. For example, section 267(a)(2) may affect the timing of a deduction otherwise disallowed under section 265(a)(2).

(4) *Special rules.* Adjusted current earnings does not include the following amounts.

(i) *Income from the discharge of indebtedness.* Amounts that are excluded from gross income under section 108 of the Internal Revenue Code of 1986 or any corresponding provision of prior law (including the Bankruptcy Tax Act of 1980, case law, income tax regulations and administrative pronouncements).

(ii) *Federal income tax refunds.* Refunds of federal income taxes.

(iii) *Income earned on behalf of states and municipalities.* Amounts that are excluded from gross income under section 115.

(5) *Treatment of life insurance contracts*—(i) *In general.* This paragraph (c)(5) addresses the treatment of life insurance contracts in determining adjusted current earnings. These rules apply to life insurance contracts as defined in section 7702. Generally, death benefits under a life insurance contract are included in adjusted current earnings, and all other distributions (including surrenders) are taxed in accordance with the principles of section 72(e), taking into account the taxpayer's basis in the contract for purposes of adjusted current earnings. If the adjusted basis in the contract for purposes of adjusted current earnings exceeds the amount of death benefits received or the amount received when the contract is surrendered (increased by the amount of any outstanding policy loan), the resulting loss is allowed as a deduction under paragraph (c)(3) of this section in computing adjusted current earnings for the taxable year. In addition, undistributed income on the contract is included in adjusted current earnings as provided in paragraph (c)(5)(ii) of this section. Paragraph (c)(5)(vi)(A) of this section provides special rules for term insurance that has no net surrender value.

(ii) *Inclusion of inside buildup.* Income on a life insurance contract with respect to a taxable year (or any shorter period either ending or beginning with the date of a distribution from the contract) is included in adjusted current earnings for the taxable year. Thus, income on the contract is calculated from the beginning of a taxable year to the date of any distribution, from immediately after any distribution to the date of the next distribution, and from the last distribution during the taxable year through the end of the taxable year. Income on a life insurance contract is not included in adjusted current earnings for any taxable year in which the insured dies or the contract is completely surrendered for its entire net surrender value. Solely for purposes of computing adjusted current earnings, the taxpayer's adjusted basis in the contract (as determined under section 72(e)(6)) is increased to reflect any positive income on the contract included in adjusted current earnings under this paragraph (c)(5)(ii). The manner in which the income on the contract is determined for adjusted current earnings purposes is prescribed in paragraph (c)(5)(iii) of this section. If the income on the contract determined under paragraph (c)(5)(iii) of this section is a negative amount, income on the contract is not included in adjusted current earnings and no deduction from adjusted current earnings is allowed for the negative amount.

(iii) *Calculation of income on the contract.* For purposes of determining adjusted current earnings, the income on a life insurance contract for any period, including a taxable year, is the excess, if any, of—

(A) The sum of the contract's net surrender value (as defined in section 7702(f)(2)(B)) at the end of the period, and any distributions under the contract during the period that, in accordance with the principles of section 72(e), are not taxed because they represent recoveries of the taxpayer's basis in the contract for adjusted current earnings, over

(B) The sum of the contract's net surrender value at the end of the preceding period, and any premiums paid under the contract during the period.

(iv) *Treatment of distributions under the life insurance contract.* Any distribution under a life insurance contract (whether a partial withdrawal or an amount received on complete surrender of the contract) is included in adjusted current earnings in accordance with the principles of section 72(e), taking into account the taxpayer's basis in the contract for purposes of computing adjusted current earnings. The taxpayer's basis in the contract is equal to the basis at the end of the immediately preceding period plus any premiums paid before the distribution. The taxpayer's basis in the contract for purposes of adjusted current earnings is reduced, in accordance with the principles of section 72(e), to the extent that the distribution is not included in adjusted current earnings because it represents a recovery of that basis.

(v) *Treatment of death benefits.* The excess of the contractual death benefit of a life insurance contract over the taxpayer's adjusted basis in the contract for purposes of computing adjusted current earnings at the time of the insured's death is included in adjusted current earnings as provided by paragraph (c)(6)(i) of this section. The amount of the death benefit that is taken into account for adjusted current earnings includes the amount of any outstanding policy loan treated as forgiven or discharged by the insurance company upon the death of the insured.

(vi) *Other rules*—(A) *Term life insurance contract without net surrender values.* Except as provided in this paragraph (c)(5)(vi), the requirements of paragraph (c)(5) of this section do not apply to term life insurance contracts that provide no net surrender value. Adjusted current earnings are reduced by any premiums paid under such a contract that are allocable to the taxable year. Any premiums paid that are not allocable to the taxable year must be included in the basis of the contract. The death benefit under such a term insurance contract is included in adjusted current earnings as provided by paragraph (c)(5)(v) of this section.

(B) *Life insurance contracts involving divided ownership.* If the ownership of a life insurance contract is divided between different persons (for example, a split-dollar arrangement), the requirements of paragraph (c)(5) of this section apply to the separate ownership interests as though each interest were a separate contract.

(vii) *Examples.* The following examples illustrate the provisions of this paragraph (c)(5).

Example 1. (i) On January 1, 1987, corporation X, a calendar year taxpayer, purchased a flexible premium life insurance contract with a death benefit of $100,000 and planned annual gross premiums of $2,200 payable on January 1 of each year. The net surrender value of the contract at the end of 1987 and subsequent years, together with the cumulative premiums for the contract at the end of each year, are set forth in the following table:

Year	Cumulative premiums paid	Year-end net surrender value
1987	$2,200	$2,420
1988	4,400	5,082
1989	6,600	8,010
1990	8,800	11,231
1991	11,000	14,774

(ii) Under paragraph (c)(5)(ii) of this section, X must include $1,021 in adjusted current earnings for 1990. The inclusion is computed by subtracting from the net surrender value of the contract at the end of the taxable year ($11,231) the sum of the net surrender value of the contract at the end of the preceding taxable year ($8,010) plus the premiums paid during the taxable year ($2,200). See paragraph (c)(5)(iii) of this section. For purposes of determining adjusted current earnings, X's adjusted basis in the contract would be increased at the end of 1990 from $8,800 to $9,821 to reflect the $1,021 inclusion. See paragraph (c)(5)(ii) of this section. The income under the contract attributable to taxable years prior to 1990 does not increase X's adjusted basis in the contract.

(iii) For 1991, the income on the contract included in adjusted current earnings is determined in the same manner as the preceding year, and there is a corresponding increase in X's adjusted basis in the contract. Thus, for 1991, the income on the contract is $1,343, which is determined by subtracting from the net surrender value of the contract at the end of the taxable year ($14,774) the sum of the net surrender value at the end of the preceding taxable year ($11,231) plus the premiums paid during the taxable year ($2,200). At the end of 1991, X's adjusted basis in the contract for adjusted current earnings is $13,364, which reflects the basis of the contract at the beginning of 1991, increased by the premium paid during the year ($2,200) and the income on the contract that has been included in adjusted current earnings for the taxable year ($1,343).

Example 2. The facts are the same as in example 1, except that, after the payment of the premium for 1991, the insured dies and X receives the $100,000 death benefit under the contract. Under paragraph (c)(5)(ii) of this section, no amount is included in adjusted current earnings for income on the contract for the taxable year in which the insured dies. Instead, under paragraph (c)(5)(v) of this section, X must include the adjusted current earnings for 1991 the excess of the death benefit ($100,000) over the adjusted basis in the contract for purposes of computing adjusted current earnings at the time of the insured's death ($12,021), which equals X's adjusted basis in the contract at the end of 1990 ($9,821), increased by X's premium payment for 1991 ($2,200).

Example 3. (i) The facts are the same as in example 1, except that in addition to making the $2,200 planned premium payment for 1992, X receives a $16,200 distribution under the contract on February 1, 1992, leaving a net surrender value of $915 immediately following the distribution. On March 1, 1992, X pays an additional premium of $5,000 under the contract. The net surrender value of the contract at the end of 1992 is $6,417.

(ii) Treatment of the distribution. Under paragraph (c)(5)(iv) of this section, the $16,200 distribution in 1992 is included in adjusted current earnings as an amount taxable in accordance with the principles of section 72(e) to the extent that the distribution ($16,200) exceeds X's adjusted basis for adjusted current earnings, as determined at the end of the immediately preceding period, and including premiums paid through the period ending on the date of the distribution ($15,564). Thus, X must include $636 in adjusted current earnings for 1992 as an amount taxable in accordance with the principles of section 72(e).

(iii) Determination of the income on the contract. Under paragraph (c)(5)(iii) of this section, for 1992, the income on the contract must be separately determined for the period beginning with the first day of the taxable year to the date of the distribution and for the period beginning immediately after the distribution to the end of the taxable year, using the contract's net surrender values at the beginning and end of each of these periods. The income on the contract for the period beginning on January 1, 1992 and ending on February 1, 1992 (the date of the distribution) is equal to the excess, if any, of (A) the sum of the net surrender value at the end of the period ($915) and the amount of the distribution that is allocable to X's basis in the contract for adjusted current earnings ($15,564), over (B) the sum of the net surrender value at the end of the preceding taxable year ($14,774) plus any premiums paid on the contract during the period ($2,200). Because the net result of this computation is a negative amount (($915 + $15,564) − ($14,774 + $2,200) = −495), no income on the contract for the period ending with the date of the distribution is included in adjusted current earnings for 1992.

(iv) Under paragraph (c)(5)(ii), X must also determine the income on the contract for the period beginning immediately after the distribution through the end of the taxable year. The income on the contract for this period is $502, which is equal to the excess of the net surrender value at the end of the taxable year ($6,417) over the sum of the net surrender value at the end of the preceding period ($915), plus any premiums paid during the period ($5,000). At the end of 1992, X's adjusted basis in the contract for adjusted current earnings is $5,502, determined by adding the income on the contract ($502) and the premiums paid during the period ($5,000) to the basis at the end of the preceding period ($0).

(v) Thus, X must include a total of $1,138 ($636 + 502) in adjusted current earnings for 1992. This inclusion reflects both the undistributed income on the contract for the taxable year plus the amount of income from distributions under the contract that is taxed in accordance with the principles of section 72(e) using X's adjusted basis in the contract for adjusted current earnings.

(6) *Partial list of income items excluded from gross income but included in earnings and profits.* The following is a partial list of items that are permanently excluded from pre-adjustment alternative minimum taxable income but that are included in earnings and profits, and are therefore included in adjusted current earnings under this paragraph (c).

(i) Proceeds of life insurance contracts that are excluded under section 101, to the extent provided in paragraph (c)(5)(v) or (c)(5)(vi) of this section.

(ii) Interest that is excluded under section 103.

(iii) Amounts received as compensation for injuries or sickness that are excluded under section 104.

(iv) Income taxes of a lessor of property that are paid by a lessee and are excluded under section 110.

(v) Income attributable to the recovery of an item deducted in computing earnings and profits in a prior year that is excluded under section 111.

(vi) Amounts received as proceeds from sports programs that are excluded under section 114.

(vii) Cost-sharing payments that are excluded under section 126, to the extent section 126(e) does not apply.

(viii) Interest on loans used to acquire employer securities that is excluded under section 133.

(ix) Financial assistance that is excluded under section 597.

(x) Amounts that are excluded from pre-adjustment alternative minimum taxable income as a result of an election under section 831(b) (allowing certain insurance companies to compute their pre-adjustment alternative minimum taxable income using only their investment income).

Items described in paragraph (c)(1) of this section must be included in earnings and profits (and therefore in adjusted current earnings) even if they are not identified in this paragraph (c)(6). The Commissioner may identify additional items described in paragraph (c)(1) in other published guidance.

(7) *Partial list of items excluded from both pre-adjustment alternative minimum taxable income and adjusted current earnings.* The following is a partial list of items that are excluded from both pre-adjustment alternative minimum taxable income and adjusted current earnings, and for which no adjustment is allowed under this section.

(i) The value of improvements made by a lessee to a lessor's property that is excluded from the lessor's income under section 109.

(ii) contributions to the capital of a corporation by a non-shareholder that are excluded from the corporation's income under section 118.

The Commissioner may identify additional items described in this paragraph (c)(7) in other published guidance.

(d) *Disallowance of items not deductible in computing earnings and profits*—(1) *In general.* Except as otherwise provided in this paragraph (d), no deduction is allowed in computing adjusted current earnings for any items that are not taken into account in determining earnings and profits for any taxable year, even if the items are taken into account in determining pre-adjustment alternative minimum taxable income. These items therefore increase adjusted current earnings to the extent they are deducted in computing pre-adjustment alternative minimum taxable income. An item of deduction is considered taken into account without regard to the timing of its deductibility in computing earnings and profits. Thus, to the extent an item is, has been, or will be deducted for purposes of determining earnings and profits, it does not increase adjusted current earnings in the taxable year in which it is deducted for purposes of determining pre-adjustment alternative minimum taxable income. For example, a deduction allowed (in determining pre-adjustment alternative minimum taxable income) under section 196 for unused research credits allowable under section 41 is taken into account in computing earnings and profits because the costs that gave rise to the credit were deductible in computing earnings and profits when incurred. Therefore, the deduction does not increase adjusted current earnings. As a further example, payments by a United States parent corporation with respect to employees of certain foreign subsidiaries, which are deductible under section 176, are considered contributions to the capital of the foreign subsidiary for purposes of computing earnings and profits. Although the payments are not deductible in computing the earnings and profits of the United States parent corporation in the year incurred, the payments do increase the parent's basis in its stock in the foreign subsidiary. This basis increase will reduce any gain the parent may later realize for purposes of computing earnings and profits on the disposition of the stock of the foreign subsidiary. Therefore, the amount of the payment by the parent is considered taken into account in computing the earnings and profits of the parent and does not increase adjusted current earnings. Thus, only deduction items that are never taken into account in computing earnings and profits are disallowed in computing adjusted current earnings under this paragraph (d).

(2) *Deductions for certain dividends received*—(i) *Certain amounts deducted under sections 243 and 245.* Paragraph (d)(1) of this section does not apply to, and adjusted current earnings therefore are not increased by, amounts deducted under sections 243 and 245 that qualify as 100-percent deductible dividends under sections 243(a), 245(b) or 245(c), or to any dividend received from a 20-percent owned corporation (as defined in section 243(c)(2)), to the extent that the dividend giving rise to the deductions is attributable to earnings of the paying corporation that are subject to federal income tax. Earnings are considered subject to federal income

tax return (that is filed or, if not, that should be filed) of an entity subject to United States taxation, even if there is no resulting United States tax liability (e.g., because of net operating losses or tax credits, other than the credit provided for in section 936).

(ii) *Special rules*—(A) *Dividends received from a foreign sales corporation.* The portion of a dividend received from a foreign sales corporation (FSC) that is classified as a 100-percent deductible dividend attributable to earnings of the FSC subject to federal income tax is that portion of the dividend distributed out of earnings and profits of the FSC attributable to non-exempt foreign trade income determined under either of the administrative pricing methods of section 925(a) (1) or (2), and to non-exempt foreign trade income determined under section 925(a)(3) that is effectively connected with the conduct of a trade or business in the United States (determined without regard to section 921). If the FSC is a 20-percent owned corporation (as defined in section 243(c)(2)), an additional portion of that dividend is classified as being attributable to earnings of the FSC subject to federal income tax to the extent that the dividend is distributed out of earnings and profits of the FSC attributable to effectively connected income (as defined in section 245(c)(4)(B)). A FSC is defined in section 922 and, for purposes of this paragraph, includes a small FSC and a former FSC. The ordering rules for distributions from a FSC set forth in §1.926(a)–1T(b)(1) apply to determine the classification of earnings and profits out of which a distribution has been made.

(B) *Dividends received from a section 936 corporation.* For example, assume that a section 936 corporation earns $100 of income in its current taxable year, $10 of which is not eligible for the credit under section 936. If the section 936 corporation makes a distribution of $50 during that year, $5 of that distribution ($10 of income not eligible for the section 936 credit divided by $100 of income, times $50 distributed) is deemed to be attributable to earnings of the paying corporation that are subject to federal income tax.

(iii) *Special rule for certain dividends received by certain cooperatives.* Paragraph (d)(1) of this section does not apply to, and adjusted current earnings do not include, any dividend received by any organization to which part I of subchapter T of the Code applies and that is engaged in the marketing of agricultural or horticultural products, if the dividend is paid by a FSC and is allowable as a deduction under section 245(c).

(3) *Partial list of items not deductible in computing earnings and profits.* The following is a partial list of items that are not taken into account in computing earnings and profits and thus are not deductible in computing adjusted current earnings.

(i) Unrecovered losses attributable to certain damages that are deductible under section 186, to the extent those damages were previously deducted in computing earnings and profits.

(ii) The deduction for small life insurance companies allowed under section 806.

(iii) Dividends deductible under the following sections of the Code:

(A) Dividends received by corporations that are deductible under section 243, to the extent paragraph (d)(2)(i) of this section does not apply.

(B) Dividends received on certain preferred stock that are deductible under section 244.

(C) Dividends received from certain foreign corporations that are deductible under section 245, to the extent neither paragraph (d)(2)(i) nor (d)(2)(iii) of this section applies.

(D) Dividends paid on certain preferred stock of public utilities that are deductible under section 247.

(E) Dividends paid to an employee stock ownership plan that are deductible under section 404(k).

(F) Non-patronage dividends that are paid and deductible under section 1382(c)(1).

Items described in paragraph (d)(1) of this section are not taken into account in computing earnings and profits (and thus are not deductible in computing adjusted current earnings) even if they are not identified in this paragraph (d)(3). The Commissioner may identify additional items described in paragraph (d)(1) of this section in other published guidance.

(4) *Partial list of items deductible for purposes of computing both pre-adjustment alternative minimum taxable income and adjusted current earnings.* The following is a partial list of items that are deductible for purposes of computing both pre-adjustment alternative minimum taxable income and adjusted current earnings, and for which no adjustment is allowed under this section.

(i) Payments by a United States corporation with respect to employees of certain foreign corporations that are deductible under section 176.

(ii) Dividends paid on deposits by thrift institutions that are deductible under section 591.

(iii) Life insurance policyholder dividends that are deductible under section 808.

(iv) Dividends paid by cooperatives that are deductible under sections 1382(b) or 1382(c)(2) and that are not paid with respect to stock.

The Commissioner may identify additional items described in this paragraph (d)(4) in other published guidance.

(e) *Treatment of income items included, and deduction items not allowed, in computing pre-adjustment alternative minimum taxable income.* Adjusted current earnings includes any income item that is included in pre-adjustment alternative minimum taxable income, even if that income item is not included in earnings and profits for the taxable year. Except as specifically provided in paragraph (c)(3) or (c)(5) of this section, no deduction is allowed for an item in computing adjusted current earnings if the item is not deductible in computing pre-adjustment alternative minimum taxable income for the taxable year, even if the item is deductible in computing earnings and profits for the year. Thus, for example, capital losses in excess of capital gains for the taxable year are not deductible in computing adjusted current earnings for the taxable year.

(f) *Certain other earnings and profits adjustments*—(1) *Intangible drilling costs.* For purposes of computing adjusted current earnings, the amount allowable as a deduction for intangible drilling costs (as defined in section 263(c)) for amounts paid or incurred in taxable years beginning after December 31, 1989, is determined as provided in section 312(n)(2)(A). See section 56(h) for an additional adjustment to alternative minimum taxable income based on energy preferences for taxable years beginning after 1990.

(2) *Certain amortization provisions do not apply.* For purposes of computing adjusted current earnings, sections 173 (relating to circulation expenditures) and 248 (relating to organizational expenditures) do not apply to amounts paid or incurred in taxable years beginning after December 31, 1989. If an election is made under section 59(e) to amortize circulation expenditures described in section 173 over a three-year period, the expenditures to which the election applies are deducted ratably over the three-year period for purposes of computing taxable income, pre-adjustment alternative minimum taxable income, and adjusted current earnings.

(3) *LIFO recapture adjustment*—(i) *In general.* Adjusted current earnings are generally increased or decreased by the increase or decrease in the taxpayer's LIFO recapture amount (as defined in paragraph (f)(3)(iii)(A) of this section) as of the close of each taxable year.

(ii) *Beginning LIFO and FIFO inventory.* For purposes of computing the increase or decrease in the LIFO recapture amount, the beginning LIFO and FIFO inventory amounts for the first taxable year beginning after December 31, 1989, are—

(A) The ending LIFO inventory amount used in computing pre-adjustment alternative minimum taxable income for the last year beginning before January 1, 1990; and

(B) The ending FIFO inventory amount for the last year beginning before January 1, 1990, computed with the adjustments described in section 56 (other than the adjustment described in section 56(g)) and section 58, the items of tax preference described in section 57 and using the methods used in computing pre-adjustment alternative minimum taxable income.

(iii) *Definitions*—(A) *LIFO recapture amount*—(*1*) *Definition.* The taxpayer's LIFO recapture amount is the excess, if any, of—

(*i*) the inventory amount of its assets under the FIFO method, computed using the rules of this section; over (*ii*) the inventory amount of its assets under the LIFO method, computed using the rules of this section.

(*2*) *Assets included.* Only the assets for which the taxpayer uses the LIFO method to compute pre-adjustment alternative minimum taxable income are taken into account in determining the LIFO recapture amount.

(B) *FIFO Method.* For purposes of this paragraph, the LIFO method is the first in, first out method described in section 471, determined by using—

(*1*) The retail method if that is the method the taxpayer uses in computing pre-adjustment alternative minimum taxable income; or

(*2*) The lower of cost or market method for all other taxpayers.

(C) *LIFO method.* The LIFO method is the last in, first out method authorized by section 472.

(D) *Inventory amounts.* Except as otherwise provided, inventory amounts are computed using the methods used in computing pre-adjustment alternative minimum taxable income. To the extent inventory is treated as produced or acquired during taxable years beginning after December 31, 1989, the inventory amount is determined with the adjustments described in sections 56 and 58 and the items of tax preference described in section 57. Thus, for example, the amount of depreciation to be capitalized under section 263A with respect to inventory produced in taxable years beginning after December 31, 1989, is based on the depreciation allowed under the rules of paragraph (b) of this section. See paragraph (a)(5) of this section.

(iv) *Exchanges under sections 351 and 721.* For purposes of this section, any decrease in a transferor's LIFO recapture amount that occurs as a result of a transfer of inventories in an exchange to which section 351 or section 721 applies cannot be used to decrease the adjusted current earnings of the transferor. A decrease that is disallowed under the preceding sentence is instead carried over to reduce any LIFO recapture adjustment that the transferee (or its corporate partners, if section 721 applies) would otherwise make (in the absence of this paragraph (f)(3)(iv)) solely by reason of its carryover basis in inventories received in the section 351 or section 721 exchange. Nothing in this paragraph (f)(3)(iv), however, alters the computation of the LIFO recapture amount of the transferor or transferee as of the close of any taxable year.

(v) *Examples.* The following examples illustrate the provisions of this paragraph (f)(3).

Example 1. M Corporation, a calendar-year taxpayer, uses the LIFO method of accounting for its inventory for purposes of computing pre-adjustment alternative minimum taxable income. M's ending LIFO inventory for all of its pools for purposes of computing pre-adjustment alternative minimum taxable income on December 31, 1989, is $300. M computes a $500 FIFO inventory amount on that date, after applying the provisions of section 263A along with the adjustments and preferences required in computing pre-adjustment alternative minimum taxable income. M's FIFO and LIFO ending inventory amounts at the close of its taxable years, its LIFO reserves, and its adjustment under this paragraph (f)(3), are as follows:

	1989	1990	1991	1992
Ending inventory:				
A. FIFO	[1] $500	$360	$560	$600
B. LIFO	[2] 300	180	320	440
LIFO recapture amount:				
A − B	200	180	240	160
Change in LIFO recapture amount and adjustment under paragraph (f)(3)	....	(20)	60	(80)

[1] Beginning FIFO inventory amount under paragraph (f)(3)(ii).
[2] Beginning LIFO inventory amount under paragraph (f)(3)(ii).

Example 2. (A) X Corporation, a calendar-year taxpayer, uses the LIFO method for purposes of computing pre-adjustment alternative minimum taxable income. X's LIFO recapture amount is $300 as of December 31, 1992, and is $200 as of December 31, 1993. Immediately prior to calculating its LIFO recapture amount as of December 31, 1993, X transfers inventory with an adjusted current earnings (ACE) basis of $500 to Y Corporation in an exchange to which section 351 applies. X determines that the $100 decrease in its LIFO recapture amount occurred as a result of its transfer of inventories to Y in the section 351 exchange. Thus, under paragraph (f)(3)(iv) of this section, X cannot decrease its adjusted current earnings by that amount. In computing its 1994 LIFO recapture adjustment, X will use $200 as its LIFO recapture amount as of December 31, 1993, even though it was not entitled to reduce adjusted current earnings by the $100 decrease in its LIFO recapture amount in 1993.

(B) For purposes of computing its ACE, Y takes a $500 carryover basis in the inventories received from X. If Y, a newly formed calendar-year taxpayer, engages in no other inventory transactions in 1993 and adopts the LIFO inventory method on its 1993 tax return, it will have a LIFO recapture amount of $0 as of December 31, 1993 (because its FIFO inventory amount and its LIFO inventory amount are both $500). Assume that at December 31, 1994, Y has a LIFO recapture amount of $200 ($1,000 FIFO inventory amount − $800 LIFO inventory amount). Under paragraph (f)(3)(i) of this section, Y computes a LIFO recapture adjustment for 1994 of $200 ($200 − $0). If any portion of Y's $200 LIFO recapture adjustment occurs solely by reason of its carryover basis in the inventories it received from X, Y reduces its $200 LIFO recapture adjustment by that portion under paragraph (f)(3)(iv). In any event, however, Y will use its $200 LIFO recapture amount as of December 31, 1994, in computing its 1995 LIFO recapture adjustment.

(vi) *Effective date.* Paragraph (f)(3) is effective for taxable years beginning after December 18, 1992. A taxpayer may choose to apply this paragraph, however, to all taxable years beginning after December 31, 1989.

(4) *Installment sales*—(i) *In general.* Adjusted current earnings are computed without regard to the installment method, except as provided in this paragraph (f)(4).

(ii) *Exception for prior dispositions.* Paragraph (f)(4)(i) of this section does not apply to any disposition in a taxable year beginning before January 1, 1990, that is taken into account under the installment method for purposes of computing pre-adjustment alternative minimum taxable income. Thus, for any disposition in a taxable year beginning before January 1, 1990, the installment method applies in computing adjusted current earnings for taxable years beginning after December 31, 1989, to the same extent it applies in determining pre-adjustment alternative minimum taxable income for the taxable year.

(iii) *Special rules for obligations to which section 453A applies*—(A) *In general.* The following special rules apply to any installment sale occurring in a taxable year beginning after December 31, 1989, that results in an installment obligation to which section 453A(a)(1) applies and with respect to which preadjustment alternative minimum taxable income is determined under the installment method. As explained in paragraph (f)(4)(iii)(B) of this section, for purposes of computing adjusted current earnings, a portion of the contract price is eligible for the installment method, and the remainder of the contract price is not eligible for the installment method. Payments under the obligation are allocated prorata between the two accounting methods.

(B) *Limitation on application of installment method.* Only a portion of the contract price of an installment sale described in paragraph (f)(4)(iii)(A) of this section is eligible to be accounted for under the installment method for purposes of computing adjusted current earnings. The portion eligible for the installment method is equal to the total contract price of the sale multiplied by the applicable percentage (as determined under section 453A(c)(4)) for the taxable year of the sale. The remainder of the contract price is not eligible to be accounted for under the installment method for purposes of computing adjusted current earnings. The gross profit ratio is determined without regard to this bifurcated treatment of the sale.

(C) *Treatment of the ineligible portion.* The gain on the sale that is taken into account in the taxable year of the sale for purposes of computing adjusted current earnings is equal to the gross profit ratio multiplied by the entire portion of the contract price that is ineligible for the installment method.

(D) *Treatment of the eligible portion.* For purposes of calculating adjusted current earnings, the amount of gain recognized in a taxable year on the portion of the contract price that is eligible for the installment method is equal to—

(*1*) The amount of payments received during the taxable year, multiplied by

(*2*) The applicable percentage for the taxable year of the sale, multiplied by

(*3*) The gross profit ratio.

(E) *Coordination with the pledge rule.* For purposes of determining the amount of payments received during the taxable year under paragraph (f)(4)(iii)(D), the rules of section 453A(d) (relating to the treatment of certain pledge proceeds as payments) apply. This includes the rules under section 453A(d)(3) that relate to treating later payments as receipts of amounts on which tax has already been paid.

(F) *Example.* The following example illustrates the provisions of this paragraph (f)(4)(iii):

(*1*) On January 1, 1990, corporation A, a calendar-year taxpayer, sells a building with an adjusted basis for purposes of computing adjusted current earnings of $10 million, for $5 million and an installment obligation bearing adequate stated interest with a principal amount of $20 million. The installment obligation calls for 4 annual payments of $5 million on January 1 of 1991, 1992, 1993, and 1994. A does not elect out of the installment method, and disposes of no other property under the installment method during 1990. No gain with respect to the sale is recaptured pursuant to section 1250.

(*2*) The gross profit percentage for purposes of computing adjusted current earnings on the sale is 60 percent, computed as follows: gross profit of $15 million ($25 million contract price less $10 million adjusted basis) divided by $25 million contract price. The applicable percentage on the sale is 75 percent, computed as follows: $15 million ($20 million of installment obligations arising during and outstanding at the end of 1990 less $5 million) divided by $20 million of installment obligations arising during and outstanding at the end of 1990. See section 453A(c)(4). The portion of the contract price eligible for accounting under the installment method for purposes of computing adjusted current earnings is $18.75 million, or $25 million total contract price times applicable percentage of 75 percent. The portion of the contract price ineligible for the installment method is $6.25 million, or $25 million less $18.75 million.

(*3*) In computing adjusted current earnings for 1990, A must include $3.75 million of the gain on the sale. This amount is equal to the portion of the contract price that is ineligible for the installment method times the gross profit ratio, or $6.25 million times 60 percent. A must also include $2.25 million of gain from the $5 million payment received in 1990. This amount is computed as follows: the eligible portion of the payment, $3.75 million ($5 million payment times the applicable percentage of 75 percent), times the gross profit ratio of 60 percent. Thus, the total amount of gain from the sale that A must include in adjusted current earnings for 1990 is $6 million ($3.75 million of gain from the portion of the contract price that is not eligible for the installment method, plus $2.25 million of gain from the 1990 payment).

(*4*) A does not pledge or otherwise accelerate payments on the note in any other taxable year. In computing adjusted current earnings for 1991, 1992, 1993, and 1994, A therefore includes $2.25 million of gain on the installment sale, computed as follows: $5 million payment times the applicable percentage of 75 percent, times the gross profit ratio of 60 percent.

(g) *Disallowance of loss on exchange of debt pools.* [Reserved]

(h) *Policy acquisition expenses of life insurance companies*—(1) *In general.* This paragraph (h) addresses the treatment of policy acquisition expenses of life insurance companies in determining adjusted current earnings. Policy acquisition expenses are those expenses that, under generally accepted accounting principles in effect at the time the expenses are incurred, are considered to vary with and to be primarily related to the acquisition of new and renewal insurance policies. Generally, these acquisition expenses must be capitalized and amortized for purposes of adjusted current earnings over the reasonably estimated life of the acquired policy, using a method that provides a reasonable allowance for amortization. This method of amortization is treated as if it applied to all taxable years in determining the amount of policy acquisition expenses deducted for adjusted current earnings. The rules in this paragraph (h) apply to any life insurance company, as defined in section 816(a).

(2) *Reasonably estimated life.* The reasonably estimated life of an acquired policy is determined based on the facts with respect to each policy (such as the age, sex, and health of the insured), and the company's experience (such as mortality, lapse rate and renewals) with similar policies. A company may treat as the reasonably estimated life

of an acquired policy the period for amortizing expenses of the acquired policy that would be required by the Financial Accounting Standards Board (FASB) at the time the acquisition expenses are incurred. If the FASB has not established such a period, the period for amortizing acquisition expense of an acquired policy under guidelines issued by the American Institute of Certified Public Accountants in effect at the time the acquisition expenses are incurred may be treated as the reasonably estimated life of the acquired policy.

(3) *Reasonable allowance for amortization*. For purposes of determining a reasonable allowance for amortization, a company may use a method that amortizes acquisition expenses in the same proportion that gross premiums and gross investment income for the taxable year bear to total anticipated receipts of gross premiums (including anticipated renewal premiums) and gross investment income to be realized over the reasonably estimated life of the policy.

(4) *Safe harbor for public financial statements*. Any company that is required to file with the Securities and Exchange Commission (SEC) a financial statement with respect to the taxable year will be treated as having complied with paragraph (h)(1) of this section if it accounts for acquisition expenses for adjusted current earnings purposes in the same manner as it accounts for those expenses on its financial statements filed with the SEC.

(i) [Reserved]

(j) *Depletion*. For purposes of computing adjusted current earnings, the allowance for depletion with respect to any property placed in service in a taxable year beginning after December 31, 1989 is determined under the cost depletion method of section 611.

(k) *Treatment of certain ownership changes*—(1) *In general*. In the case of any corporation that has an ownership change as defined in paragraph (k)(2) of this section in a taxable year beginning after December 31, 1989, and that also has a net unrealized built-in loss (as defined in paragraph (k)(3) of this section) immediately before the ownership change, the adjusted basis of each asset of the corporation for purposes of computing adjusted current earnings following the ownership change shall be its proportionate share (determined on the basis of the respective fair market values of each asset) of the fair market value of the assets of the corporation immediately before the ownership change. The rules of §1.338–6(b), if otherwise applicable to the transaction, are applied in making this allocation of basis. If such rules apply, the limitations of §§1.338–6(c) (1) and (2) also apply in allocating basis under this paragraph (k)(1).

(2) *Definition of ownership change*. A corporation has an ownership change for purposes of section 56(g)(4)(G)(i) and this paragraph (k) if there is an ownership change under section 382(g) for purposes of computing the corporation's amount of taxable income that may be offset by pre-change losses or the regular tax liability that may be offset by pre-change credits. See §1.382–2T for rules to determine whether a corporation has an ownership change. Accordingly, in order for an ownership change to occur for purposes of this paragraph (k), a corporation must be a loss corporation as defined in §1.382–2(a)(1). In determining whether the corporation is a loss corporation, the determination of whether there is a net unrealized built-in loss is made by using the aggregate adjusted basis of the assets of the corporation used in computing taxable income. The aggregate adjusted basis of the corporation's assets for purposes of computing adjusted current earnings is not relevant in determining whether the corporation is a loss corporation. See part (iv) of the example in paragraph (k)(4) of this section.

(3) *Determination of net unrealized built-in loss immediately before an ownership change*. In order to determine whether it has a net unrealized built-in loss for purposes of section 56(g)(4)(G)(ii) and paragraph (k)(1) of this section, a corporation that has an ownership change as defined in paragraph (k)(2) of this section must use the aggregate adjusted basis of its assets that it uses in computing its adjusted current earnings. The rules of section 382 (including sections 382(h)(3)(B)(i) and 382(h)(8)) otherwise

apply in determining whether the corporation has a net unrealized built-in loss.

(4) *Example*. The following example illustrates the provisions of this paragraph (k):

(i) Individual A has owned all the issued and outstanding stock of corporation L for the past 5 years. A sells all of his stock in L to unrelated individual B. On the date of the sale, L owns the following assets (all numbers are in millions):

Asset	Adjusted basis for computing taxable income	Adjusted basis for computing adjusted current earnings	Fair market value
x	$45	$50	$50
y	55	60	30
z	10	10	20
	$110	$120	$100

For purposes of computing taxable income, L has a $500 million net operating loss carryforward to the taxable year in which the sale occurs. Therefore, L is a loss corporation. As a result of the transfer of shares of L from A to B, L has had an ownership change.

(ii) L has no net unrealized built-in loss for purposes of computing taxable income because the amount by which the aggregate adjusted basis of its assets for that purpose exceeds their fair market value is $10 million, which is less than 15 percent of their fair market value and is not greater than $10 million. See section 381(h)(3)(B)(i). L, however, does have a net unrealized built-in loss for purposes of computing adjusted current earnings because the aggregate adjusted basis of its assets for the purpose exceeds their fair market value by $20 million, and that amount is greater than $10 million.

(iii) Under paragraph (k)(1) of this section, L must restate the adjusted basis of its assets for purposes of computing adjusted current earnings to their fair market values, as follows (all numbers are in millions):

Asset	New adjusted basis
x	$50
y	30
z	20

L must use these new adjusted bases for all purposes in determining adjusted current earnings, including computing depreciation and any gain or loss on disposition.

(iv) If L did not have the net operating loss carryforward, and had no other loss or credit carryovers or other attributes described in §1.382–2(a)(1) for purposes of computing the amount of its taxable income that may be offset by pre-change losses or its regular tax liability that may be offset by pre-change credits, it would not have been a loss corporation on the date of the sale and therefore would not be treated as having had an ownership change for purposes of computing adjusted current earnings. This would be true even though L had a net unrealized built-in loss for purposes of computing adjusted current earnings. Therefore, this paragraph (k) would not have applied.

(l) [Reserved]

(m) *Adjusted current earnings of a foreign corporation*—(1) *In general*. The alternative minimum taxable income of a foreign corporation is increased by 75 percent of the excess of—

(i) Its effectively connected adjusted current earnings for the taxable year; over

(ii) Its effectively connected pre-adjustment alternative minimum taxable income for the taxable year.

(2) *Definitions*—(i) *Effectively connected pre-adjustment alternative minimum taxable income*. Effectively connected pre-adjustment alternative minimum taxable income is the effectively connected taxable income of the foreign corporation for the taxable year, determined with the adjustments under sections 56 and 58 (except for the adjustment for adjusted current earnings, the alternative tax net operating loss and the alternative tax energy preference deduction) and increased by the tax preference items of section 57, but taking into account only items of income of the foreign corporation that are effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States, and any expense, loss or deduction that is properly allocated and apportioned to that income.

(ii) *Effectively connected adjusted current earnings*. Effectively connected adjusted current earnings is the effectively connected pre-adjustment alternative minimum taxable income of the foreign corporation for the taxable year, adjusted under section 56(g) and this section, but taking into account only items of income of the foreign corporation that are effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States, and any expense, loss or deduction that is properly allocated and apportioned to that income.

(3) *Rules to determine effectively connected pre-adjustment alternative minimum taxable income and effectively connected adjusted current earnings.* The principles of section 864 (c) (and the regulations thereunder) and any other applicable provision of the Internal Revenue Code apply to determine whether items of income of the foreign corporation are effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States, and whether any expense, loss or deduction is properly allocated and apportioned to that income.

(4) *Certain exempt amounts.* Effectively connected adjusted current earnings and effectively connected pre-adjustment alternative minimum taxable income do not include any item of income, or any expense, loss or deduction that is properly allocated and apportioned to income that is exempt from United States taxation under section 883 or an applicable income tax treaty. See section 894.

(n) *Adjustment for adjusted current earnings of consolidated groups*—(1) *Positive adjustments.* For taxable years beginning after December 31, 1989, the alternative minimum taxable income of a consolidated group (as defined in §1.1502–1T) is increased by 75 percent of the excess, if any, of—

(i) The consolidated adjusted current earnings for the taxable year, over

(ii) The consolidated pre-adjustment alternative minimum taxable income for the taxable year.

(2) *Negative adjustments*—(i) *In general.* The alternative minimum taxable income of a consolidated group is decreased, subject to the limitation of paragraph (n)(2)(ii) of this section, by 75 percent of the excess, if any, of the consolidated pre-adjustment alternative minimum taxable income over consolidated adjusted current earnings.

(ii) *Limitation on negative adjustments.* The amount of the negative adjustment for any taxable year shall be limited to the excess, if any, of—

(A) The aggregate increases in the alternative minimum taxable income of the group in prior years under this section, over

(B) The aggregate decreases in the alternative minimum taxable income of the group in prior years under this section.

(3) *Definitions*—(i) *Consolidated pre-adjustment alternative minimum taxable income.* Consolidated pre-adjustment alternative minimum taxable income is the consolidated taxable income (as defined in §1.1502–11) of a consolidated group for the taxable year, determined with the adjustments provided in sections 56 and 58 (except for the adjustment for adjusted current earnings and the alternative tax net operating loss determined under section 56(a)(4)) and increased by the preference items described in section 57.

(ii) *Consolidated adjusted current earnings.* The consolidated adjusted current earnings of a consolidated group is the consolidated pre-adjustment alternative minimum taxable income of the consolidated group for the taxable year, adjusted as provided in section 56(g) and this section.

(4) *Example.* The following example illustrates the provisions of this paragraph (n):

(i) P is the common parent of a consolidated group. In 1990, the group has consolidated pre-adjustment alternative minimum taxable income of $1,400,000 and consolidated adjusted current earnings of $1,600,000. Thus, the group has a consolidated adjustment for adjusted current earnings for 1990 of $150,000 (75 percent of the $200,000 excess of consolidated adjusted current earnings over consolidated pre-adjustment alternative minimum taxable income), and alternative minimum taxable income of $1,550,000 ($1,400,000 plus $150,000).

(ii) In 1991, the group has consolidated pre-adjustment alternative minimum taxable income of $1,500,000 and consolidated adjusted current earnings of $1,100,000. Thus, the group can reduce its alternative minimum taxable income by $150,000. The potential negative adjustment of $300,000 (75 percent of the $400,000 excess of consolidated pre-adjustment alternative minimum taxable income over consolidated adjusted current earnings) is limited to the $150,000 consolidated adjustment for adjusted current earnings taken into account in 1990.

(o) [Reserved]

(p) *Effective dates for corporate partners in partnerships*—(1) *In general.* The provisions of this section apply to a corporate partner's distributive share of items of income and expense from a partnership for any taxable year of the partnership ending within or with any taxable year of the corporate partner beginning after December 31, 1989.

(2) *Application of effective dates.* Solely for purposes of the effective date provisions of this section, a partnership event (such as placing property in service, paying or incurring a cost, or closing an installment sale) is deemed to occur on the last day of the partnership's taxable year.

(3) *Example.* The following example illustrates the provisions of this paragraph (p):

(i) X is a calendar-year corporation that is a partner in P, an accrual-basis partnership with a taxable year ending March 31. During P's taxable year ending March 31, 1990, P earned ratably throughout the year interest income on tax-exempt obligations. In addition, P incurred intangible drilling costs in November 1989 and in February 1990.

(ii) X's adjusted current earnings for 1990 includes X's distributive share of the interest on the tax-exempt obligations earned by P for its taxable year ending March 31, 1990. This is true even though P earned a portion of the interest prior to January 1, 1990.

(iii) For purposes of computing X's adjusted current earnings for 1990, the adjustment provided in paragraph (f)(1) of this section applies to X's distributive share of P's November 1989 and February 1990 intangible drilling costs.

(q) *Treatment of distributions of property to shareholders*—(1) *In general.* If a distribution of an item of property by a corporation with respect to its stock gives rise to more than one adjustment to earnings and profits under section 312, all of the adjustments with respect to that item of property (including the adjustment described in section 312(c) with respect to liabilities to which the item is subject or which are assumed in connection with the distribution) are combined for purposes of determining the corporation's adjusted current earnings for the taxable year. If the amount included in pre-adjustment alternative minimum taxable income with respect to a distribution of an item of property exceeds the net increase in earnings and profits caused by the distribution, pre-adjustment alternative minimum taxable income is not reduced in computing adjusted current earnings. If the net increase in earnings and profits caused by a distribution of an item of property exceeds the amount included in pre-adjustment alternative minimum taxable income with respect to the distribution, that excess is added to pre-adjustment alternative minimum taxable income in computing adjusted current earnings.

(2) *Examples.* The following examples illustrate the provisions of this paragraph (q).

(i) *Example 1.* K corporation distributes property with a fair market value of $150 and an adjusted basis of $100. The adjusted basis is the same for purposes of computing taxable income, pre-adjustment alternative minimum taxable income, adjusted current earnings, and earnings and profits. Under section 312(a)(3), as modified by section 312(b)(2), K decreases its earnings and profits by the fair market value of the property, or $150. Under section 312(b)(1), K increases its earnings and profits by the excess of the fair market value of the property over its adjusted basis, or $50. As a result of the distribution, there is a net decrease in K's earnings and profits of $100. K recognizes $50 of gain under section 311(b) as a result of the distribution as if K sold the property for $150. K thus has no amount permanently excluded from pre-adjustment alternative minimum taxable income that is taken into account in determining current earnings and profits, and thus has no adjustment under paragraph (c)(1) of this section.

(ii) *Example 2.* The facts are the same as in example 1, except that the distribution shareholder assumes a $190 liability in connection with the disribution. Under section 312(c)(1), K must adjust the adjustments to its earnings and profits under section 312 (a) and (b) to account for the liability the shareholder assumes. K adjusts the $100 net decrease in its earnings and profits to reflect the $190 liability, resulting in an increase in its earnings and profits of $90. Because section 311(b)(2) makes the rules of section 336(b) apply, the fair market value of the property is not less than the amount of the liability, or $190. K therefore is treated as if it sold the property for $190, recognizing $90 of gain. K thus has no amount permanently excluded from pre-adjustment alternative minimum taxable income that is taken into account in determining current earnings and profits, and thus has no adjustment under paragraph (c)(1) of this section.

(r) *Elections to use simplified inventory methods to compute alternative minimum tax*—(1) *In general.* If a taxpayer makes an election under this paragraph (r) (and does not make the election in paragraph (r)(5) of this section), the rules of paragraph (r)(2) of this section apply in computing the taxpayer's pre-adjustment alternative minimum taxable income and adjusted current earnings.

(2) *Effect of election*—(i) *Inventories.* The taxpayer's inventory amounts as determined for purposes of computing taxable income are used for purposes of computing pre-adjustment alternative minimum taxable income and adjusted current earnings. Subject to the further modification described in paragraph (r)(2)(ii) of this section, the taxpayer's cost of sales as determined for purposes of computing taxable income is also used for purposes of computing pre-adjustment alternative minimum taxable income and adjusted current earnings.

(ii) *Modifications required*—(A) *In general.* If a taxpayer makes an election under this paragraph (r), pre-adjustment alternative minimum taxable income and adjusted current earnings are computed with the modifications described in this paragraph. The items of adjustment under sections 56 and 58 and the items of tax preference under section 57 are computed without regard to the portion of those adjustments and preferences which, but for the election described in this paragraph, would have been capitalized in ending inventory. For example, pre-adjustment alternative minimum taxable income is increased by the excess of the depreciation allowable for the taxable year under section 168 for purposes of computing taxable income (determined without regard to section 263A) over the depreciation allowable for the taxable year under section 56(a)(1) and section 57 for purposes of computing pre-adjustment alternative minimum taxable income (determined without regard to section 263A). Similarly, adjusted current earnings is further increased by the excess of the depreciation allowable for the taxable year under section 56(a)(1) and section 57 for purposes of computing pre-adjustment alternative minimum taxable income (determined without regard to section 263A) over the depreciation allowable for the taxable year under section 56(g)(4)(A) for purposes of computing adjusted current earnings (determined without regard to section 263A). Thus, the modifications described in the preceding sentence do not duplicate amounts that are taken into account in computing pre-adjustment alternative minimum taxable income. See paragraph (a)(6)(ii) of this section.

(B) *Negative modifications allowed.* An election under this paragraph (r) does not affect the taxpayer's ability to make negative adjustments. Thus, if an election is made under this paragraph (r) and the amount of any adjustment under section 56 or 58, determined after modification under paragraph (r)(2)(ii)(A) of this section, is a negative amount, then this amount reduces pre-adjustment alternative minimum taxable income or adjusted current earnings. However, no negative adjustment under this paragraph (r)(2)(ii)(B) is allowed for the items of tax preference under section 57.

(iii) *LIFO recapture adjustment.* If a taxpayer makes an election under this paragraph (r) and uses the LIFO method for some assets, for purposes of computing the LIFO recapture adjustment under paragraph (f)(3) of this section for taxable years beginning after December 31, 1989—

(A) The LIFO inventory amount as determined for purposes of computing taxable income is used in lieu of the LIFO inventory amount as determined under paragraph (f)(3)(iii) of this section;

(B) The FIFO inventory amount is computed without regard to the adjustments under sections 56 (including the adjustments of section 56(g)(4)) and 58 and the items of tax preference of section 57; and

(C) The beginning LIFO and FIFO inventory amounts under paragraph (f)(3)(ii) of this section are the ending

LIFO inventory amount as determined for purposes of computing taxable income and the ending FIFO inventory amount computed without regard to the adjustments under sections 56 (including the adjustments of sections 56(g)(4)) and 58 and the items of tax preference of section 57 for the last taxable year beginning before January 1, 1990.

(3) *Time and manner of making election*—(i) *Prospective election*. (A) A prospective election under this paragraph (r) may be made by any taxpayer—

(*1*) That has computed pre-adjustment alternative minimum taxable income and adjusted current earnings for all prior taxable years in accordance with the method described in this paragraph (r); or

(*2*) That has not computed pre-adjustment alternative minimum taxable income and adjusted current earnings for all prior tax years in accordance with the method described in this paragraph (r), but for which the use of the method described in this paragraph (r) for all prior taxable years would not have changed the taxpayer's tax liability (as shown on returns filed as of the date the election is made) for any prior taxable year for which the period of limitations under section 6501(a) has not expired (as of the date the election is made).

(B) A prospective election under this paragraph (r) may only be made by attaching a statement to the taxpayer's timely filed (including extensions) original Federal income tax return for any taxable year that is no later than its first taxable year to which this paragraph (r) applies and in which the taxpayer's tentative minimum tax (computed under the provisions of this paragraph (r)) exceeds its regular tax. However, in the case of a taxpayer described in paragraph (r)(3)(i)(A)(*1*) of this section that had tentative minimum tax in excess of its regular tax for any prior taxable year, the election may only be made by attaching a statement to its timely filed (including extensions) original Federal income tax return for the first taxable year ending after December 18, 1992. The statement must—

(*1*) Give the name, address and employer identification number of the taxpayer; and

(*2*) Identify the election as made under this paragraph (r).

(C) The determination of whether a taxpayer is described in paragraph (r)(3)(i)(A)(*2*) of this section is to be made as of the time the taxpayer makes a prospective election in accordance with the procedures in paragraph (r)(3)(i)(B) of this section.

(D) Any taxpayer described in paragraph (r)(3)(i)(A)(*2*) of this section that makes a prospective election will be deemed to have used the method described in this paragraph (r) in computing pre-adjustment alternative minimum taxable income and adjusted current earnings for all prior taxable years.

(ii) *Retroactive election*—(A) A retroactive election under this paragraph (r) may be made by any taxpayer not described in paragraph (r)(3)(i)(A) (*1*) or (*2*) of this section. Except as provided in paragraph (r)(3)(iii) of this section, a retroactive election may only be made by attaching a statement to the taxpayer's amended Federal income tax return for the earliest taxable year for which the period of limitations under section 6501(a) has not expired and which begins after December 31, 1986. The amended return to which the election under this paragraph (r)(3)(ii) is attached must be filed no later than June 21, 1993.

(B) The amended return must contain the statement described in paragraph (r)(3)(i)(B) of this section. In addition, the statement must contain a representation that the taxpayer will modify its pre-adjustment alternative minimum taxable income and adjusted current earnings for all open taxable years in accordance with paragraph (r)(2) of this section. Upon this change in method of accounting, the taxpayer must include the entire adjustment required under section 481(a), if any, in preadjustment alternative minimum taxable income and adjusted current earnings on the amended return for the year of the election. The taxpayer must also reflect the method of accounting described in paragraph (r)(2) of this section on amended returns filed for all taxable years after the year of the election for which returns were originally filed before making the election (and for which the period of limitations under section 6501(a) has not expired).

(C) Provided a taxpayer meets the requirements of this paragraph (r), any change in method of accounting arising as a result of making a retroactive election will be treated as made with the advance consent of the Commissioner.

(D) Any retroactive election under this paragraph (r) that is made without filing amended returns required under this paragraph (r)(3)(ii) shall constitute a change in method of accounting made without the consent of the Commissioner.

(iii) *Taxpayers under examination*—(A) *In general.* A taxpayer that wishes to make a retroactive election under section (r)(3)(ii) of this section may use the procedures in paragraph (r)(3)(iii)(A) (*1*) or (*2*) in lieu of filing an amended return for any taxable year that is under examination by the Internal Revenue Service.

(*1*) *Year of change under examination.* If the year of the change is under examination at the time the taxpayer timely makes the election, the taxpayer may (in lieu of filing an amended return for the year of the change) furnish the written statement described in paragraph (r)(3)(iii)(B) of this section to the revenue agent responsible for examining the taxpayer's return no later than June 21, 1993. It is the taxpayer's responsibility to make a timely election either by furnishing the statement to the revenue agent or by filing amended returns by June 21, 1993.

(*2*) *Other open years under examination.* If any other year for which the taxpayer must modify its pre-adjustment alternative minimum taxable income and adjusted current earnings (see paragraph (r)(3)(ii)(B) of this section) is examined, the taxpayer may (in lieu of filing an amended return) furnish the amount of the conforming adjustment to the revenue agent responsible for examining the taxpayer's return. It is the taxpayer's responsibility to timely modify its pre-adjustment alternative minimum taxable income and adjusted current earnings for each year other than the year of change, either by furnishing the amount of the adjustment to the revenue agent or by filing amended returns.

(B) *Statement required.* The statement required under paragraph (r)(3)(iii)(A)(*1*) of this section must include all of the items required under paragraph (r)(3)(ii)(B) of this section, as well as—

(*1*) The caption ''Election to use regular tax inventories for AMT purposes;''

(*2*) A description of the nature and amount of all items that would result in adjustments and that the taxpayer would have reported if the taxpayer had used the method described in this paragraph (r) for all prior taxable years for which the period of limitations under section 6501(a) has not expired and which begin after December 31, 1986; and

(*3*) The following declaration signed by the person authorized to sign the return for the taxpayer: ''Under penalties of perjury, I declare that I have examined this written statement, and to the best of my knowledge and belief this written statement is true, correct, and complete.''

(C) *Year of change.* The year of change is the earliest taxable year for which the period of limitations under section 6501(a) has not expired at the time the statement is submitted to the appropriate revenue agent and that begins after December 31, 1986. Thus, the adjustments required to be included on the statement must include any adjustment under section 481(a) determined as if the method described in this paragraph (r) had been used in all taxable years prior to the year of change that begin after December 31, 1986.

(D) *Treatment of additional tax liability.* Any additional tax liability that results from the adjustments identified in the written statement described in paragraph (r)(3)(iii)(B) of this section is treated as an additional amount of tax shown on an amended return.

(iv) *Election as method of accounting.* The elections provided in paragraphs (r)(3) (i) and (ii) of this section constitute either adoptions of, or changes in, methods of accounting. These elections, once made, may be revoked only with the consent of the Commissioner in accordance with the rules of section 446(e) and § 1.446–1(e).

(v) *Untimely election to use simplified inventory method.* If a taxpayer makes an election described in this paragraph (r) after the times set forth in paragraph (r)(3) (i) or (ii) of this section, the taxpayer must comply with the requirements of § 1.446–1(e)(3) in order to secure the consent of the Commissioner to change to the method of accounting prescribed in this paragraph (r). The taxpayer generally will be subject to terms and conditions designed to place the taxpayer in a position no more favorable than a taxpayer that timely complied with paragraph (r)(3) (i) and (ii) of this section, whichever is applicable.

(4) *Example.* The following example illustrates the provisions of this paragraph (r).

Example. (i) Corporation L is a calendar year manufacturer of baseball bats and uses the LIFO method of accounting for inventories. During 1987, 1988, and 1989, L's cost of goods sold in computing taxable income was as follows:

	1987	1988	1989
Beginning LIFO inventory	$3,000	$4,000	$5,000
Purchases and other costs	9,000	9,000	9,000
Ending LIFO inventory	(4,000)	(5,000)	(6,000)
Cost of goods sold	8,000	8,000	8,000

(ii) L has no preferences under section 57 during 1987, 1988, and 1989. L's sole adjustment in computing alternative minimum tax during 1987, 1988, and 1989 was the depreciation adjustment under section 56(a)(1). Depreciation determined for both production and non-production assets under section 168 and under section 56(a)(1) during 1987, 1988, and 1989 was as follows:

	1987	1988	1989
Section 168 depreciation	$1,800	$1,800	$1,800
Section 56(a)(1) depreciation	(900)	(900)	(900)
Depreciation difference	900	900	900
Portion of difference capitalized in the increase in inventory	(100)	(100)	(100)
Adjustment required under section 56(a)(1)	800	800	800

(iii) In computing taxable income, a portion of each year's section 168 depreciation attributable to production assets is deducted currently and a portion is capitalized into the increase in ending inventory. For 1987, 1988, and 1989, L computed alternative minimum tax by deducting the cost of goods sold which was reflected in taxable income ($8,000) in accordance with paragraph (r)(2)(i) of this section. For 1987, 1988, and 1989, L also modified its adjustments under sections 56 and 58 and its preferences under section 57 to disregard the portion of any adjustment or preference that was capitalized in inventory. Thus, under section 56(a)(1), L increased alternative minimum taxable income during each year by $900.

(iv) L is eligible to make the election under paragraph (r)(1) of this section in accordance with paragraph (r)(3)(i) of this section (a prospective election).

(v) L must compute its LIFO recapture adjustment for each year by reference to—

(A) The FIFO inventory amount after applying the provisions of section 263A but before applying the adjustments of sections 56 and 58 and the items of preference in section 57; and

(B) The LIFO inventory amount used in computing taxable income.

(5) *Election to use alternative minimum tax inventories to compute adjusted current earnings.* A taxpayer may elect under this paragraph (r)(5) to use the inventory amounts used to compute pre-adjustment alternative minimum taxable income in computing its adjusted current earnings. Rules similar to those of paragraphs (r)(2) and (r)(3) of this section apply for purposes of this election.

(s) *Adjustment for alternative tax energy preference deduction*—(1) *In general.* For purposes of computing adjusted current earnings, any taxpayer claiming a deduction under section 56(h) must properly decrease basis by the portion of the deduction allowed under section 56(h) which is attributable to adjustments under section 56(g)(4). In taxable years following the taxable year in which the section 56(h) deduction is claimed, basis recovery (including amortization, depletion, and gain on sale) must properly take into account this basis reduction.

(2) *Example*. The following example illustrates the provisions of this paragraph (s):

Example. Corporation A, a calendar year taxpayer, incurs $100 of intangible drilling costs on January 1, 1994 and as a result of these intangible drilling costs A claims a deduction under section 56(h) of $40. Assume that $20 of A's deduction under section 56(h) is attributable to the adjustment under paragraph (f)(1) of this section. A must reduce by $20 the amount of intangible drilling costs to be amortized under paragraph (f)(1) of this section in 1995 through 1998 (the balance of the 60-month amortization period).

[T.D. 8340, 56 FR 11084, Mar. 15, 1991, as amended by T.D. 8352, 56 FR 29433, June 27, 1991; T.D. 8454, 57 FR 60477, Dec. 21, 1992; T.D. 8482, 58 FR 42207, Aug. 9, 1993; T.D. 8566, 59 FR 51371, Oct. 11, 1994; T.D. 8858, 65 FR 1237, Jan. 7, 2000; T.D. 8940, 66 FR 9929, Feb. 13, 2001]

Tax Preference Regulations

§ 1.57–0 Scope.

For purposes of the minimum tax for tax preferences (subtitle A, chapter I, part VI), the items of tax preference are:

(a) Excess investment interest,

(b) The excess of accelerated depreciation on section 1250 property over straight line depreciation,

(c) The excess of accelerated depreciation on section 1245 property subject to a net lease over straight line depreciation,

(d) The excess of the amortization deduction for certified pollution control facilities over the depreciation otherwise allowable,

(e) The excess of the amortization deduction for railroad rolling stock over the depreciation otherwise allowable,

(f) The excess of the fair market value of a share of stock received pursuant to a qualified or restricted stock option over the exercise price,

(g) The excess of the addition to the reserve for losses on bad debts of financial institutions over the amount which have been allowable based on actual experience,

(h) The excess of the percentage depletion deduction over the adjusted basis of the property, and

(i) The capital gains deduction allowable under section 1202 or an equivalent amount in the case of corporations.

Accelerated depreciation on section 1245 property subject to a net lease and excess investment interest are not items of tax preference in the case of a corporation, other than a personal holding company (as defined in section 542) and an electing small business corporation (as defined in section 1371(b)). In addition, excess investment interest is an item of tax preference only for taxable years beginning before January 1, 1972. Rules for the determination of the items of tax preference are contained in §§ 1.57–1 through 1.57–5. Generally, in the case of a nonresident alien or foreign corporation, the application of §§ 1.57–1 through 1.57–5 will be limited to cases in which the taxpayer has income effectively connected with the conduct of a trade or business within the United States. Special rules for the treatment of items of tax preference in the case of certain entities and the treatment of items of tax preference relating to income from sources outside the United States are provided in section 58 and in §§ 1.58–1 through 1.58–8.

[T.D. 7564, 43 FR 40470, Sept. 12, 1978]

§ 1.57–1 Items of tax preference defined.

(a) [Reserved]

(b) *Accelerated depreciation on section 1250 property*—(1) *In general*. Section 57(a)(2) provides that, with respect to each item of section 1250 property (as defined in section 1250(c)), there is to be included as an item of tax preference the amount by which the deduction allowable for the taxable year for depreciation or amortization exceeds the deduction which would have been allowable for the taxable year if the taxpayer had depreciated the property under the straight line method for each year of its useful life for which the taxpayer has held the property. The determination of the excess under section 57(a)(2) is made with respect to each separate item of section 1250 property.

Accordingly, where the amount of depreciation which would have been allowable with respect to one item of section 1250 property if the taxpayer had originally used the straight line method exceeds the allowable depreciation or amortization with respect to such property, such excess may not be used to reduce the amount of the item of tax preference resulting from another item of section 1250 property.

(2) *Separate items of section 1250 property.* The determination of what constitutes a separate item of section 1250 property is to be made on the facts and circumstances of each individual case. In general, each building (or component thereof, if the taxpayer uses the component method of computing depreciation) is a separate item of section 1250 property. However, for purposes of this section, assets placed in a group, classified, or composite account are to be treated as a single item by a taxpayer, provided that such account contains only property placed in service during a single taxable year. In addition, two or more items may be treated as one item of section 1250 property for purposes of this paragraph where, with respect to each such item:

(i) The period for which depreciation is taken begins on the same date, (ii) the same estimated useful life has continually been used for purposes of taking depreciation or amortization, and (iii) the same method (and rate) of depreciation or amortization has continually been used. For example, assume a taxpayer constructed a 40-unit rental townhouse development and began taking declining balance depreciation on all 40 units as of January 1, 1970, at a uniform rate and has consistently taken depreciation on all 40 units on this same basis. Although each townhouse is a separate item of section 1250 property, all 40 townhouses may be treated as one item of section 1250 property for purposes of the minimum tax since the conditions of subdivisions (i), (ii), and (iii) of this subparagraph are met. This would be true even if the 40 townhouses comprised two 20-unit developments located apart from each other. However, if the taxpayer constructed an additional development or new section on the existing development for which he began taking depreciation on July 1, 1970, at a uniform rate for all the additional units, the additional units and the original units may not be treated as one item of section 1250 property since the condition of subdivision (i) of this subparagraph is not met. Where a portion of an item of section 1250 property has been depreciated or amortized under a method (or rate) which is different from the method (or rate) under which the other portion or portions of such item have been depreciated or amortized, such portion is considered a separate item of section 1250 property for purposes of this paragraph.

(3) *Allowable depreciation or amortization.* The phrase ''deduction allowable for the taxable year for exhaustion, wear and tear, obsolescence, or amortization'' and references in this paragraph to ''allowable depreciation or amortization'' include deductions allowable for the taxable year under sections 162, 167, 212, or 611 for the depreciation or amortization of section 1250 property. Such phrase does not include depreciation allowable in the year in which the section 1250 property is disposed of. For the determination of ''allowable depreciation or amortization'' for taxable years in which the taxpayer has taken no deduction, see §1.1016–3(a)(2).

(4) *Straight line depreciation.* (i) For purposes of computing the depreciation which would have been allowable for the taxable year if the taxpayer had depreciated the property under the straight line method for each taxable year of its useful life, the taxpayer must use the same useful life and salvage value as was used for the first taxable year in which the taxpayer depreciated or amortized the property (subject to redeterminations made pursuant to §1.167(a)–1 (b) and (c)). If, however, for any taxable year, no useful life was used under the method of depreciation or amortization used or an artificial period was used, such as, for example, by application of section 167(k), or salvage value was not taken into account in determining the annual allowances, such as, for example, under the declining balance method, then, for purposes of computing the depreciation which would have been allowable under

the straight line method for the taxable year—

(*a*) There is to be used the useful life and salvage value which would have been proper if depreciation had actually been determined under the straight line method (without reference to an artificial life) throughout the period the property was held, and

(*b*) Such useful life and such salvage value is to be determined by taking into account for each taxable year the same facts and circumstances as would have been taken into account if the taxpayer had used such method throughout the period the property was held.

If an election under §1.167(a)–11(f), §1.167(a)–12(e), or §1.167(a)–12(f) is applicable to the property, the salvage value of the property shall be determined in accordance with such election, and the asset depreciation period (or asset guideline period) applicable to the property pursuant to such election shall be considered to be the useful life of the property for the purposes of this section.

(ii) Where the taxpayer acquires property in a transaction to which section 381(a) applies or from another member of an affiliated group during a consolidated return year and an ''accelerated'' method of depreciation as described in section 167(b) (2), (3), or (4) or section 167(j)(1) (B) or (C) is permitted (see §1.381(c)(6)–1 and §1.1502–12(g)), the depreciation which would have been allowable under the straight line method is determined as if the property had been depreciated under the straight line method since depreciation was first taken on the property by the transferor of such property. In such cases, references in this paragraph to the period for which the property is held or useful life of the property are treated as including the period beginning with the commencement of the original use of the property.

(iii) For purposes of section 57(a)(2), the straight line method includes the method of depreciation described in §1.167(b)–1 or any other method which provides for a uniform proration of the cost or other basis (less salvage value) of the property over the estimated useful life of the property to the taxpayer (in terms of years, hours of use, or other similar time units) or estimated number of units to be produced over the life of the property to the taxpayer. If a method other than the method described in §1.167(b)–1 is used, the estimated useful life or estimated units of production shall be determined in a manner consistent with subdivision (i) of this subparagraph.

(iv) In the case of property constructed by or improvements made by a lessee, the useful life is to be determined in accordance with §1.167(a)–4.

(5) *Application for partial period.* If an item is section 1250 property for less than the entire taxable year, the allowable depreciation or amortization includes only the depreciation or amortization for that portion of the taxable year during which the item is section 1250 property and the amount of the depreciation which would have been allowable under the straight line method is determined only with regard to such portion of the taxable year.

(6) *No section 1250 and basis adjustment.* No adjustment is to be made as a result of the minimum tax either to the basis of section 1250 property or with respect to computations under section 1250.

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

Example. The taxpayer's only item of section 1250 property is an office building with respect to which operations were commenced on January 1, 1971. The taxpayer depreciates the component parts of the building on the declining balance method. The useful life and costs of the component parts for depreciation purposes are as follows:

Asset	Useful life	Cost	Salvage value
Building shell	50	$400,000	$50,000
Partitions and walls	10	40,000	
Ceilings	10	20,000	
Electrical system	25	40,000	2,500
Heating and air-conditioning system	25	60,000	2,500

For purposes of computing the item of tax preference under this paragraph for the taxpayer, the partitions, walls, and ceilings may be grouped together and the electrical, heating, and air-conditioning systems may be grouped together since the period for which depreciation is taken began with respect to the assets within these two groups on the same date and the assets within each group have continually had the same useful life and have continually been depreciated under the same method (and rate).

(a) The taxpayer's 1971 item of tax preference under this paragraph would be determined as follows:

(1)	(2)	(3)	(4)
Item of 1250 property	Declining balance depreciation	Straight line depreciation	Excess of (2) over (3)
1. Shell	$12,000	$7,000	$5,000
2. Partitions, walls, ceilings	9,000	6,000	3,000
3. Electrical, heating and air-conditioning systems	6,000	3,800	2,200
1971 preference			10,200

(b) Assuming the above facts are the same for 1974, the taxpayer's 1974 item of tax preference under this paragraph would be determined as follows:

(1)	(2)	(3)	(4)
Item of 1250 property	Declining balance depreciation	Straight line depreciation	Excess of (2) over (3)
1. Shell	$10,952	$7,000	$3,952
2. Partitions, walls, ceilings	5,529	6,000	None
3. Electrical, heating and air-conditioning systems	4,983	3,800	1,183
1974 preference			5,135

(c) *Accelerated depreciation on section 1245 property subject to a net lease*—(1) *In general*. Section 57(a)(3) provides that, with respect to each item of section 1245 property (as defined in section 1245(a)(3)) which is the subject of a net lease for the taxable year, there is to be included as an item of tax preference the amount by which the deduction allowable for the taxable year for depreciation or amortization exceeds the deduction which would have been allowable for the taxable year if the taxpayer had depreciated the property under the straight line method for each year of its useful life for which the taxpayer has held the property. Except as provided in paragraph (b)(1)(ii) of this section, the determination of the excess under section 57(a)(3) is made with respect to each separate item of section 1245 property. Accordingly, where the amount of depreciation which would have been allowable with respect to one item of section 1245 property if the taxpayer had originally used the straight line method exceeds the allowable depreciation or amortization with respect to such property, such excess may not be used to reduce the amount of the item of tax preference resulting from another item of section 1245 property.

(2) *Separate items of property*. The determination of what constitutes a separate item of section 1245 property must be made on the facts and circumstances of each individual case. Such determination shall be made in a manner consistent with the principles expressed in paragraph (b)(2) of this section.

(3) *Allowable depreciation or amortization*. The phrase "deduction allowable for the taxable year for exhaustion, wear and tear, obsolescence, or amortization" and references in this paragraph to "allowable depreciation or amortization" include deductions allowable for the taxable year under sections 162, 167 (including depreciation allowable under section 167 by reason of section 179), 169, 184, 185, 212, or 611 for the depreciation or amortization of section 1245 property. Such phrase does not include depreciation allowable in the year in which the section 1245 property is disposed of. Amortization of certified pollution control facilities under section 169, and amortization of railroad rolling stock under section 184 are not to be treated as amortization

for purposes of section 57(a)(3) to the extent such amounts are treated as an item of tax preference under section 57(a) (4) or (5) (see paragraphs (d) and (e) of this section). For the determination of ''allowable depreciation or amortization'' for taxable years in which the taxpayer has taken no deduction, see § 1.1016–3(a)(2).

(4) *Straight line method of depreciation.* The determination of the depreciation which would have been allowable under the straight line method shall be made in a manner consistent with paragraph (b)(4) of this section. Such amount shall include any amount allowable under section 167 by reason of section 179 (relating to additional first-year depreciation for small business).

(5) *Application for partial period.* If an item is section 1245 property for less than the entire taxable year or subject to a net lease for less than the entire taxable year the allowable depreciation or amortization includes only the depreciation or amortization for that portion of the taxable year during which the item was both section 1245 property and subject to a net lease and the amount of the depreciation which would have been allowable under the straight line method is to be determined only with regard to such portion of the taxable year.

(6) *Net lease.* Section 57(a)(3) applies only if the section 1245 property is the subject of a net lease for all or part of the taxable year. See § 1.57–3 for the determination of when an item is considered the subject of a net lease. p

(7) *No section 1245 and basis adjustment.* No adjustment is to be made as a result of the minimum tax either to the basis of section 1245 property or with respect to computations under section 1245.

(8) *Nonapplicability to corporations.* Section 57(a)(3) does not apply to a corporation other than an electing small business corporation (as defined in section 1371(b)) and a personal holding company (as defined in section 542).

(d) *Amortization of certified pollution control facilities*—(1) *In general.* Section 57(a)(4) provides that, with respect to each certified pollution control facility for which an election is in effect under section 169, there is to be included as an item of tax preference the amount by which the deduction allowable for the taxable year under such section exceeds the depreciation deduction which would otherwise be allowable under section 167. The determination under section 57(a)(4) is made with respect to each separate certified pollution control facility. Accordingly, where the amount of the depreciation deduction which would otherwise be allowable under section 167 with respect to one facility exceeds the allowable amortization deduction under section 169 with respect to such facility, such excess may not be used to offset an item of tax preference resulting from another facility.

(2) *Separate facilities.* The determination of what constitutes a separate facility must be made on the facts and circumstances of each individual case. Generally, each facility with respect to which a separate election is in effect under section 169 shall be treated as a separate facility for purposes of this paragraph. However, if the depreciation or amortization which would have been allowable without regard to section 169 with respect to any part of a facility is based on a different useful life, date placed in service, or method of depreciation or amortization from the other part or parts of such facility, such part is considered a separate facility for purposes of this paragraph. For example, if a building constitutes a certified pollution control facility and various component parts of the building have different useful lives, each group of component parts with the same useful life would be treated as a separate facility for purposes of this paragraph. Two or more facilities may be treated as one facility for purposes of this paragraph where, with respect to each such facility: (i) The initial amortization under section 169 commences on the same date, (ii) the facility is placed in service on the same date, (iii) the estimated useful life which would be the basis for depreciation or amortization other than under section 169 has continually been the same, and (iv) the method of depreciation or amortization which could have been used without regard to section 169 could have continually been the same.

(3) *Amount allowable under section 169.* For purposes of the determination of

the amount of the deduction allowable under section 169, see section 169 and the regulations thereunder. Such amount, however, does not include amortization allowable in the year in which the pollution control facility is disposed of.

(4) *Otherwise allowable deduction.* (i) The determination of the amount of the depreciation deduction otherwise allowable under section 167 is made as if the taxpayer had depreciated the property under section 167 for each year of its useful life for which the property has been held. This amount may be determined under §1.167(a)–(11)(c) if the property is eligible property (as defined in §1.167(a)–11(b)(2)) and, during the taxable year in which the property was first placed in service, the taxpayer—

(*a*) Has made an election under §1.167(a)–11(f) with respect to eligible property first placed in service in such taxable year, or

(*b*) Has placed no eligible property in service other than property described in §1.167(a)–11(b)(5) (iii), (iv), or (v).

The amount determined pursuant to the preceding sentence shall be determined as if the taxpayer had depreciated the property in accordance with §1.167(a)–11 for all years to which such section applies and during which the taxpayer held the property. This amount may be determined under §1.167(a)–12(a)(5) if the property is qualified property (as defined in §1.167(a)–12(a)(3)) and the taxpayer has made an election with respect to such property under §1.167(a)–12(e). If the taxpayer has made an election under §1.167(a)–12(f)(1) for a taxable year ending before January 1, 1971, this amount shall be determined for such year in accordance with such election. For purposes of this determination, any method selected by the taxpayer which would have been permissible under section 167 for such taxable year, including accelerated methods, may be used. Any additional amount which would have been allowable by reason of section 179 (relating to additional first-year depreciation for small business) may be included provided such amount is reflected in the determination made under this paragraph in subsequent years.

(ii) If a deduction for depreciation has not been taken by the taxpayer in any taxable year under section 167 with respect to the facility—

(*a*) There is to be used the useful life and salvage value which would have been proper under section 167.

(*b*) Such useful life and salvage value is determined by taking into account for each taxable year the same facts and circumstances as would have been taken into account if the taxpayer had used such method throughout the period the property has been held, and

(*c*) The date the property is placed in service is, for purposes of this section, deemed to be the first day of the first month for which the amortization deduction is taken with respect to the facility under section 169.

If, prior to the date amortization begins under section 169, a deduction for depreciation has been taken by the taxpayer in any taxable year under section 167 with respect to the facility, the useful life, salvage value, etc., used for that purpose is deemed to be the appropriate useful life, salvage value, etc., for purposes of this paragraph, with such adjustments as are appropriate in light of the facts and circumstances which would have been taken into account since the time the last such depreciation deduction was taken, unless it is established by clear and convincing evidence that some other useful life, salvage value, or date the property is placed in service is more appropriate.

(iii) For purposes of section 57(a)(4) and this paragraph, if the deduction for amortization or depreciation which would have been allowable had no election been made under section 169 would have been—

(*a*) An amortization deduction based on the term of a leasehold or

(*b*) A depreciation deduction determined by reference to section 611,

such deduction is to be deemed to be a deduction allowable under section 167.

(iv) If a facility is subject to amortization under section 169 for less than the entire taxable year, the otherwise allowable depreciation deduction under section 167 shall be determined only with regard to that portion of the taxable year during which the election under section 169 is in effect.

(v) If less than the entire adjusted basis of a facility is subject to amortization under section 169, the otherwise allowable depreciation deduction under section 167 shall be determined only with regard to that portion of the adjusted basis subject to amortization under section 169.

(5) *No section 1245 and basis adjustment.* No adjustment is to be made as a result of the minimum tax either to the basis of a certified pollution control facility or with respect to computations under sections 1245.

(6) *Relationship to section 57(a)(3).* See paragraph (c)(3) with respect to an adjustment in the amount treated as amortization under that provision where both paragraphs (3) and (4) of section 57(a) are applicable to the same item of property.

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

Example. A calendar year taxpayer has a certified pollution control facility on which an election is in effect under section 169 commencing with January 1, 1971. No part of the facility is section 1250 property. The original basis of the facility is $100,000 of which $75,000 constitutes amortizable basis. The useful life of the facility is 20 years. The taxpayer depreciates the $25,000 portion of the facility which is not amortizable basis under the double declining method and began taking depreciation on January 1, 1971.

(a) The taxpayer's 1971 item of tax preference under this paragraph would be determined as follows:

1. Amortization deduction	$15,000
2. Depreciation deduction on amortizable basis (double declining method)	7,500
1971 preference (excess of 1 over 2)	7,500

(b) If the taxpayer terminated his election under section 169 in 1972 effective as of July 1, 1972, the taxpayer's 1972 item of tax preference would be determined as follows:

1. Amortization deduction	$7,500
2. Depreciation deduction on amortizable basis:	
Full year ($75,000 (original basis) less $7,500 ("depreciation" to 1–1–72) equals adjusted basis of $67,500; multiplied by 0.10 (double declining rate))	6,750
Portion of full year's depreciation attributable to amortization period (one-half)	3,375
1972 preference (excess of 1 over 2)	4,125

(e) *Amortization of railroad rolling stock*—(1) *In general.* Section 57(a)(5) provides that, with respect to each unit of railroad rolling stock for which an election is in effect under section 184, there is to be included as an item of tax preference the amount by which the deduction allowable for the taxable year under such section exceeds the depreciation deduction which would otherwise be allowable under section 167. The determination under section 57(a)(5) is made with respect to each separate unit of rolling stock. Accordingly, where the amount of the depreciation deduction which would otherwise be allowable under section 167 with respect to one unit exceeds the allowable amortization deduction under section 184 with respect to such unit, such excess may not be used to offset an item of tax preference resulting from another unit.

(2) *Separate units of rolling stock.* The determination of what constitutes a separate unit of rolling stock must be made on the facts and circumstances of each individual case. Such determination shall be made in a manner consistent with the manner in which the comparable determination is made with respect to separate certified pollution control facilities under paragraph (d) (2) of this section.

(3) *Amount allowable under section 184.* For purposes of the determination of the amount of the deduction allowable under section 184, see section 184. Such amount, however, does not include amortization allowable in the year in which the rolling stock is disposed of.

(4) *Otherwise allowable deduction.* The determination of the amount of the depreciation deduction otherwise allowable under section 167 is to be made in a manner consistent with the manner in which the comparable deduction with respect to certified pollution control facilities is determined under paragraph (d)(4) of this section.

(5) *No section 1245 or basis adjustment.* No adjustment is to be made as a result of the minimum tax either to the basis of a unit of railroad rolling stock or with respect to computations under section 1245.

(6) *Relationship to section 57(a)(3).* See paragraph (c)(3) of this section with respect to an adjustment in the amount treated as amortization under that provision where both paragraphs (3) and

(5) of section 57(a) are applicable to the same item.

(f) *Stock options*—(1) *In general.* Section 57(a)(6) provides that with respect to each transfer of a share of stock pursuant to the exercise of a qualified stock option or a restricted stock option, there shall be included by the transferee as an item of tax preference the amount by which the fair market value of the share at the time of exercise exceeds the option price. The stock option item of tax preference is subject to tax under section 56(a) in the taxable year of the transferee in which the transfer is made.

(2) *Definitions.* See generally §1.421–7 (e), (f), and (g) for the definitions of "option price," "exercise," and "transfer," respectively; however, in the case of a transfer of a share of stock pursuant to the exercise of a qualified stock option or a restricted stock option after the death of an employee by the estate of the decedent (or by a person who acquired the right to exercise such option by bequest or inheritance or by reason of the death of the decedent), the term "option price" shall, for purposes of this paragraph, include both the consideration paid by the estate (or such person) for such share of stock and so much of the basis of the option as is attributable to such share of stock. For the definition of a qualified stock option see section 422(b) and §1.422–2. For the definition of a restricted stock option see section 424(b) and §1.424–2. The definitions and special rules contained in section 425 and the regulations thereunder are applicable to this paragraph.

(3) *Fair market value.* In accordance with the principles of section 83(a)(1), the fair market value of a share of stock received pursuant to the exercise of a qualified or restricted stock option is to be determined without regard to restrictions (other than nonlapse restrictions within the meaning of §1.83–3(h)). Notwithstanding any valuation date given in section 83(a)(1), for purposes of this section, fair market value is determined as of the date the option is exercised.

(4) *Foreign source options.* In the case of an option attributable to sources within any foreign country or possession, see section 58(g) and §1.58–8.

(5) *Inapplicability in certain cases.* (i) Section 57(a)(6) is inapplicable if during the same taxable year in which stock is transferred pursuant to the exercise of an option, the transferee makes a disposition (within the meaning of section 425(c)) of such stock. In the case of a nonresident alien, section 57(a)(6) is inapplicable to the extent the stock option is attributable (in accordance with the principles of sections 861 through 863 and the regulations thereunder) to sources without the United States.

(ii) Section 57(a)(6) is inapplicable if section 421(a) does not apply to the transfer because of employment requirements of section 422(a)(2) or 424(a)(2).

(6) *Proportionate applicability.* Where, by reason of section 422 (b)(7) and (c)(3) (relating to percentage ownership limitations), only a portion of a transfer qualifies for application of section 421, the fair market value and option price shall be determined only with regard to that portion of the transfer which so qualifies.

(7) *No basis adjustment.* No adjustment shall be made to the basis of the stock received pursuant to the exercise of a qualified or restricted stock option as a result of the minimum tax.

(g) *Reserves for losses on bad debts of financial institutions*—(1) *In general.* Section 57(a)(7) provides that, in the case of a financial institution to which section 585 or 593 (both relating to reserves for losses on loans) applies, there shall be included as an item of tax preference the amount by which the deduction allowable for the taxable year for a reasonable addition to a reserve for bad debts exceeds the amount that would have been allowable had the institution maintained its bad debt reserve for all taxable years on the basis of the institution's actual experience.

(2) *Taxpayers covered.* Section 57(a)(7) applies only to an institution (or organization) to which section 585 or 593 applies. See sections 585(a) and 593(a) and the regulations thereunder for a description of those institutions.

(3) *Allowable deduction.* For purposes of this paragraph, the amount of the deduction allowable for the taxable year for a reasonable addition to a reserve for bad debts is the amount of the

deduction allowed under section 166(c) by reference to section 585 or 593.

(4) *Actual experience.* (i) For purposes of this paragraph, the determination of the amount which would have been allowable had the institution maintained its reserve for bad debts on the basis of actual experience is the amount determined under section 585(b)(3)(A) and the regulations thereunder. For this purpose, the beginning balance for the first taxable year ending in 1970 is the amount which bears the same ratio to loans outstanding at the beginning of the taxable year as (*a*) the total bad debts sustained during the 5 preceding taxable years, adjusted for recoveries of bad debts during such period, bears to (*b*) the sum of the loans outstanding at the close of such 5 taxable years. The taxpayer may, however, select a more appropriate balance based on its actual experience during a shorter period subject to the approval of the district director upon examination of the return provided there are unusual circumstances which indicate that such period is more indicative of the taxpayer's actual loss experience. Any such selection and approval shall be made in a manner consistent with the selection and approval of a bad debt reserve method under §1.166–1(b). In the case of an institution which has been in existence for less than 5 taxable years as of the beginning of the first taxable year ending in 1970, the above formula for determining the beginning balance is applied by substituting the number of taxable years for which the institution has been in existence as of the beginning of the taxable year for ''5'' each time it appears. If any taxable year utilized in the above formula for determining the beginning balance is a short taxable year the amount of the bad debts, adjusted for recoveries, for such taxable year is modified by dividing such amount by the number of days in the taxable year and multiplying the resulting amount by 365. The beginning balance for any subsequent taxable year is the amount of the beginning balance of the preceding taxable year, decreased by bad debt losses during such year, increased by recoveries of bad debts during such year and increased by the lower of the maximum amount determined under section 585(b)(3)(A) for such year or the amount of the deduction allowed for such year. The application of this subdivision (i) may be illustrated by the following example:

Example. The Y Bank, a calendar year taxpayer, uses the reserve method of acounting for bad debts. On December 31, 1969, Y determines the balance of its reserve for bad debts to be $70,000 under the percentage method. On the same date Y's 5-year moving average is $52,000. Y incurs net bad debt losses (bad debt losses less recoveries of bad debts) of $3,000 for each of the years 1970, 1971, and 1972, which it charges to its reserve for bad debts. Y's 6-year moving averages computed under section 585(b)(3)(A) at the close of 1970, 1971, and 1972 are $50,000, $49,000, and $51,000, respectively. Y's preference items are computed as follows based upon additional facts assumed:

	1970	1971	1972
1. Bad debt reserve—percentage method:			
(a) Balance beginning of year (closing balance prior year)	$70,000	$70,000	$68,000
(b) Net bad debts charged to reserve	3,000	3,000	3,000
(c) Subtotal	67,000	67,000	65,000
(d) Deduction allowed	3,000	1,000	4,000
(e) Balance end of year	70,000	68,000	69,000
2. Bad debt reserve—''actual experience'':			
(a) Beginning balance (for 1970, 5-year moving average; for other years, closing balance prior year)	52,000	50,000	48,000
(b) Net bad debts charged to reserve	3,000	3,000	3,000
(c) Subtotal	49,000	47,000	45,000
(d) Maximum amount under section 585 (b)(3)(A) (6-year moving average minus (c))	1,000	2,000	6,000
(e) Deduction allowed (line 1(d))	3,000	1,000	4,000
(f) Lower of (d) or (e)	1,000	1,000	4,000
(g) Closing balance (line (c) + (f))	50,000	48,000	49,000
3. Preference item under section 57(a)(7):			
(a) Deduction allowed	3,000	1,000	4,000

	1970	1971	1972
(b) Maximum amount under section 585(b)(3)(A)	1,000	2,000	6,000
(c) Preference item (excess of (a) over (b))	2,000	0	0

(ii) In the case of a new institution whose first taxable year ends after 1969, its beginning balance for its reserve for bad debts, for purposes of this paragraph, is zero and its reasonable addition to the reserve for such taxable year is determined on the basis of the actual experience of similar institutions located in the area served by the taxpayer.

(h) *Depletion*—(1) *In general.* Section 57(a)(8) provides that with respect to each property (as defined in section 614), there is to be included as an item of tax preference the amount by which the deduction allowable for the taxable year under section 611 for depletion for the property exceeds the adjusted basis of the property at the end of the taxable year (determined without regard to the depletion deduction for that taxable year). The determination under section 57(a)(8) is made with respect to each separate property. Thus, for example, if one mineral property has an adjusted basis remaining at the end of the taxable year, such basis may not be used to reduce the amount of an item of tax preference resulting from another mineral property.

(2) *Allowable depletion.* For the determination of the amount of the deduction for depletion allowable for the taxable year see section 611 and the regulations thereunder.

(3) *Adjusted basis.* For the determination of the adjusted basis of the property at the end of the taxable year see section 1016 and the regulations thereunder.

(4) *No basis adjustment.* No adjustment is to be made to the basis of property subject to depletion as a result ot the minimum tax.

(i) *Capital gains*—(1) *Taxpayers other than corporations.* Section 57(a)(9)(A) provides that, in the case of a taxpayer other than a corporation, there is to be included as an item of tax preference one-half of the amount by which the taxpayer's net long-term capital gain for the taxable year exceeds the taxpayer's net short-term capital loss for the taxable year. For this purpose, for taxable years beginning after December 31, 1971, the taxpayer's net long-term capital gain does not include an amount equal to the deduction allowable under section 163 (relating to interest expense) by reason of subsection (d)(1)(C) of that section, and the excess described in the preceding sentence is reduced by an amount equal to the reduction of disallowed interest expense by reason of section 163(d)(2)(B). Furthermore, the net long-term capital gain of an estate or trust does not include capital gains described in section 642(c)(4). Included in the computation of the taxpayer's capital gains item of tax preference are amounts reportable by the taxpayer as distributive shares of gain or loss from partnerships, estates or trusts, electing small business corporations, common trust funds, etc. See section 58 and the regulations thereunder with respect to the above entities.

Example. For 1971, A, a calendar year individual taxpayer, recognized $50,000 from the sale of securities held for more than 6 months. In addition, A received a $15,000 dividend from X Fund, a regulated investment company, $12,000 of which was designated as a capital gain dividend by the company pursuant to section 852(b)(3)(C). The AB partnership recognized a gain of $20,000 from the sale of section 1231 property held by the partnership. The AB partnership agreement provides that A is entitled to 50 percent of the income and gains of the partnership. A had net short-term capital loss for the year of $10,000. A's 1971 capital gains item of tax preference is computed as follows:

Capital gain recognized from securities	$50,000
Capital gain dividend from regulated investment company	12,000
Distributive share of partnership capital gain	10,000
Total net long-term capital gain	72,000
Less: net short-term capital loss	(10,000)
Excess of net long-term capital gain over net short-term capital loss	62,000
One-half of above excess	31,000

(2) *Corporations.* (i) Section 57(a)(9)(B) provides that in the case of corporations there is to be included as an item

of tax preference with respect to a corporation's net section 1201 gain an amount equal to the product obtained by multiplying the excess of the net long-term capital gain over the net short-term capital loss by a fraction. The numerator of this fraction is the sum of the normal tax rate and the surtax rate under section 11 minus the alternative tax rate under section 1201(a) for the taxable year, and the denominator of the fraction is the sum of the normal tax rate and the surtax rate under section 11 for the taxable year. Included in the above computation are amounts reportable by the taxpayer as distributive shares of gain or loss from partnerships, estates or trusts, common trust funds, etc. In certain cases the amount of the net section 1201 gain which results in preferential treatment will be less than the amount determined by application of the statutory formula. Therefore, in lieu of the statutory formula, the capital gains item of tax preference for corporations may in all cases be determined by dividing—

(*a*) The amount of tax which would have been imposed under section 11 if section 1201(a) did not apply minus—

(*b*) The amount of the taxes actually imposed

by the sum of the normal tax rate plus the surtax rate under section 11. In case of foreign source capital gains and losses which are not taken into account pursuant to sections 58(g)(2)(B) and 1.58–8, the amount determined in the preceding sentence shall be multiplied by a fraction the numerator of which is the corporation's net section 1201 gain without regard to such gains and losses which are not taken into account and the denominator of which is the corporation's net section 1201 gain. The computation of the corporate capital gains item of tax preference may be illustrated by the following examples:

Example 1. For 1971, A, a calendar year corporate taxpayer, has ordinary income of $10,000 and net section 1201 gain of $50,000, none of which is subsection (d) gain (as defined in sec. 1201(d)) and none of which is attributable to foreign sources. A's 1971 capital gain item of tax preference may be computed as follows:

1. Tax under section 11:		
Normal tax (0.22 × $60,000)		$13,200
Surtax (0.26 × $35,000)		9,100
		22,300
2. Tax under section 1201:		
(a) Normal tax on ordinary income (0.22 × $10,000)		$2,200
Tax on net section 1201 gain (0.30 × $50,000)	$15,000	$17,200
3. Excess		5,100
4. Normal tax rate plus surtax rate		.48
5. Capital gains preference (line 3 divided by line 4)		10,625

Example 2. For 1971, A, a calendar year corporate taxpayer, has a loss from operations of $30,000 and net section 1201 gain of $150,000, none of which is subsection (d) gain (as defined in section 1201(d)) and none of which is attributable to foreign sources. A's 1971 capital gain item of tax preference may be computed as follows:

1. Tax under section 11:		
Normal tax (0.22 × $120,000)		$26,400
Surtax (0.26 × $95,000)		24,700
		51,100
2. Tax under section 1201(a):		
Normal tax on ordinary income	None	
Tax on net section 1201 gain (0.30 × $150,000)	45,000	45,000
3. Excess		6,100
4. Normal tax rate plus surtax rate		.48
5. Capital gain preference (line 3 divided by line 4)		12,708

(ii) In the case of organizations subject to the tax imposed by section 511(a), mutual savings banks conducting a life insurance business (see section 594), life insurance companies (as defined in section 801), mutual insurance companies to which part II of subchapter L applies, insurance companies to which part III of subchapter L applies, regulated investment companies subject to tax under part I of subchapter M, real estate investment trusts subject to tax under part II of subchapter M, or any other corporation not subject to the taxes imposed by sections 11 and 1201(a), the capital gains item of tax preference may be computed in accordance with subdivision (i) of this subparagraph except that, in lieu of references to section 11, there is to be substituted the section which imposes the tax comparable to the tax imposed by section 11 and, in lieu of references to section 1201(a), there is to be substituted the section which imposes the alternative or special tax applicable to the capital gains of such corporation.

(iii) For purposes of this paragraph, where the net section 1201 gain is not in any event subject to the tax comparable to the normal tax and the surtax under section 11, such as in the case of regulated investment companies subject to tax under subchapter M, such comparable tax shall be computed as if it were applicable to net section 1201 gain to the extent such gain is subject to the tax comparable to the alternative tax under section 1201(a). Thus, in the case of a regulated investment company subject to tax under subchapter M, the tax comparable to the normal tax and the surtax would be the tax computed under section 852(b)(1) determined as if the amount subject to tax under section 852(b)(3) were included in investment company taxable income. The principles of this subdivision (iii) may be illustrated by the following example:

Example. M, a calendar year regulated investment company, in 1971, has investment company taxable income (subject to tax under sec. 852(b)(1)) of $125,000 and net long-term capital gain of $800,000. M company has no net short-term capital loss but has a deduction for dividends paid (determined with reference to capital gains only) of $700,000, M's 1971 capital gains item of tax preference is computed as follows:

1. Section 852(b)(1) tax computed as if it were applicable to all income including capital gains:			
Amount subject to section 852(b)(1)		$125,000	
Net section 1201 gain	$800,000		
Less: Dividends paid deduction	700,000		
Net section 1201 gain subject to tax at the company level		100,000	
		225,000	
Normal tax (0.22 × $225,000)			$49,500
Surtax (0.26 × 200,000)			52,000
			101,500
2. Tax comparable to section 1201(a) tax section 852(b)(1) tax:			
Normal tax (0.22 × 125,000)	$27,500		
Surtax (0.26 × 100,000)	26,000	$53,500	
Section 852(b)(3) tax (0.30 × 100,000)		30,000	
			$83,500
3. Excess			18,000
4. Normal tax rate plus surtax rate			.48
5. Capital gains preference (line 3 divided by line 4)			37,500

(iv) For the computation of the capital gains item of tax preference in the case of an electing small business corporation (as defined in section 1371(b)), see §1.58–4(c).

(3) *Nonresident aliens, foreign corporations.* In the case of a nonresident alien individual or foreign corporation, there shall be included in computing the capital gains item of tax preference under section 57(a)(9) only those capital gains and losses included in the computation of income effectively connected with the conduct of a trade or business within the United States as provided in section 871(b) or 882.

[T.D. 7564, 43 FR 40470, Sept. 12, 1978]

§§ 1.57–2—1.57–3 [Reserved]

§ 1.57–4 Limitation on amounts treated as items of tax preference for taxable years beginning before January 1, 1976.

(a) *In general.* If in any taxable year beginning before January 1, 1976, a taxpayer has deductions in excess of gross income and all or a part of any item of tax preference described in §1.57–1 results in no tax benefit due to modifications required under section 172(c) or section 172(b)(2) in computing the amount of the net operating loss or the net operating loss to be carried to a succeeding taxable year, then, for purposes of section 56(a)(1), the sum of the items of tax preference determined under section 57(a) (and § 1.57–1) is to be limited as provided in paragraph (b) of this section.

(b) *Limitation.* The sum of the items of tax preference, for purposes of section 56(a)(1) and § 1.56A–1(a), is limited to an amount determined under subparagraphs (1) and (2) of this paragraph.

(1) *Loss year.* If the taxpayer has no taxable income for the taxable year without regard to the net operating loss deduction, the amount of the limitation is equal to—

(i) In cases where the taxpayer does not have a net operating loss for the taxable year, the amount of the recomputed income (as defined in paragraph (c) of this section) or

(ii) In cases where the taxpayer has a net operating loss for the taxable year, the amount of the net operating loss (expressed as a positive amount) increased by the recomputed income or decreased by the recomputed loss for the taxable year (as defined in paragraph (c) of this section,

plus the amount of the taxpayer's stock option item of tax preference (as described in § 1.57–1(f)).

(2) *Loss carryover and carryback years.* Except in cases to which subparagraph (1)(ii) of this paragraph applies, if, in any taxable year to which a net operating loss is carried, a capital gains deduction is disallowed under section 172(b)(2) in computing the amount of such net operating loss which may be carried to succeeding taxable years, the amount of the limitation is equal to the amount, if any, by which the sum of the items of tax preference (computed with regard to subparagraph (1)(i) of this paragraph) exceeds the lesser of—

(i) The amount by which such loss is reduced because of a disallowance of the capital gains deduction in such taxable year, or

(ii) The capital gains deduction.

The amount determined pursuant to the preceding sentence shall be increased by the amount, if any, that such reduction is attributable to that portion of such a net operating loss described in section 56(b)(1)(B) and § 1.56A–2(a)(2) (relating to excess tax preferences).

(c) *Recomputed income or loss.* For purposes of this section, the phrase ''recomputed income or loss'' means the taxable income or net operating loss for the taxable year computed without regard to the amounts described in § 1.57–1 except paragraph (i)(2) of that section (relating to corporate capital gains) and without regard to the net operating loss deduction. For this purpose, the reference to the amounts described in § 1.57–1 is a reference to that portion of the deduction allowable in computing taxable income under the appropriate section equal to the amount which is determined in each paragraph of § 1.57–1. For example, the amount described in § 1.57–1(h) (relating to excess of percentage depletion over basis) is that portion of the deduction allowable for depletion under section 611 which is equal to the amount determined under § 1.57–1(h). For purposes of this paragraph, the amount described in § 1.57–1(i)(1) (relating to capital gains) is to be considered as the amount of the deduction allowable for the taxable year under section 1202.

(d) *Determination of preferences reduced.* When, pursuant to paragraph (b)(1) of this section, the sum of the items of tax preference (determined without regard to this section) are reduced, such reduction is first considered to be from the capital gains item of tax preference (described in § 1.57–1(i)(1)) and each item of tax preference relating to a deduction disallowed in computing the net operating loss pursuant to section 172(d), pro rata. The balance of the reduction, if any, is considered to be from the remaining items of tax preference, pro rata. For purposes of this subparagraph, deductions not attributable to the taxpayer's trade or business which do not relate to items of tax preference are considered as being applied in reducing gross income not derived from such trade or business before such deductions which do relate to items of tax preferences.

(e) *Examples.* The principles of this section may be illustrated by the following examples in each of which the deduction for the personal exemption is disregarded and the taxpayer is an individual who is a calendar year taxpayer.

Example 1. The taxpayer has the following items of income and deduction for 1970:

Gross income (all business income)	$120,000
Deductions:	
Nonbusiness deductions	30,000
Items of tax preference (excess accelerated depreciation on real property held in taxpayer's business)	80,000
Other business deductions	50,000

Based on the above figures, the taxpayer has a net operating loss of $10,000 (business deductions of $130,000 less business income of $120,000, the nonbusiness deductions having been disallowed by reason of section 172(d)(4)). The limitation on the amount treated as items of tax preference is computed as follows:

Tax preferences			$80,000
Net operating loss		$10,000	
Recomputed income or loss:			
Gross income	$120,000		
Deductions other than tax preference items	80,000		
Recomputed income		40,000	
Sum of net operating loss and recomputed income		50,000	
Stock options preference		0	
Limitation		50,000	

Thus, the minimum tax computed under section 56(a) would be 10 percent of $20,000 (items of tax preference of $50,000 less the minimum tax exemption of $30,000), $1,000 of which would be deferred tax liability pursuant to section 56(b).

Example 2. Assume the same facts as in example 1 except that the other business deductions are $130,000, resulting in a net operating loss of $90,000. The limitation on the amount treated as items of tax preference is computed as follows:

Tax preferences			$80,000
Net operating loss		$90,000	
Recomputed income or loss:			
Gross income	$120,000		
Deductions other than tax preference items	160,000		
	(40,000)		
Disallowance of nonbusiness deductions under sec. 172(d)	30,000		
Recomputed loss		10,000	
Net operating loss less recomputed loss		80,000	
Stock options preference		0	
Limitation			80,000

Thus, the minimum tax computed under section 56(a) would be 10 percent of $50,000 (items of tax preference of $80,000 less the minimum tax exemption of $30,000), all of which will be deferred tax liability pursuant to section 56(b).

Example 3. The taxpayer has the following items of income and deduction for 1970:

Gross income (all from business):			
Ordinary			$50,000
Net section 1201 gains			120,000
Deductions:			
Items of tax preference:			
Excess amortization of certified pollution control facilities		$45,000	
Capital gains deduction		60,000	105,000
Other business deductions			75,000

In addition, the taxpayer has a $55,000 item of tax preference resulting from qualified stock options. Based on the above figures, the taxpayer has no taxable income and no net operating loss as the capital gains deduction is disallowed in determining the net operating loss pursuant to section 172(d). The limitation on the amount treated as items of tax preference is computed as follows:

Tax preferences			$160,000
Net operating loss		0	
Recomputed income or loss:			
Gross income	$170,000		
Deductions other than tax preference items	75,000		
Recomputed income		$95,000	
Plus: Stock options preference		55,000	
Limitation			150,000

Thus, the minimum tax computed under section 56 would be 10 percent of $120,000 (items of tax preference of $150,000 less the minimum tax exemption of $30,000).

Example 4. Assume the same facts as in example (3) except that the taxpayer has a net operating loss carryover from 1969 of $80,000. The taxpayer has $160,000 of tax preferences which are limited to $150,000 pursuant to §1.57–4(b)(1). In order to determine the amount of the 1969 net operating loss which remains as a carryover to 1971, the 1970 taxable income is redetermined in accordance with section 172(b)(2) and the regulations thereunder, as follows:

Gross income—1970	$170,000	
Deductions:		
Capital gains deduction disallowed business deductions	$120,000	120,000
Taxable income for section 172(b)(2)		50,000

Thus, the 1969 net operating loss which remains as a carryover to 1971 is $30,000. Pursuant to paragraph (b)(2) of this section, the limitation on the amount treated as items of tax preference is computed as follows:

Items of tax preference computed with regard to § 1.57–4(b)(1) (per example (3))	$150,000
Less: Lesser of capital gains deduction ($60,000) or amount of reduction in carryover due to its disallowance ($50,000)	50,000
Limitation	100,000

Thus, the minimum tax computed under section 56 would be 10 percent of $70,000 (items of tax preference of $100,000 less the minimum tax exemption of $30,000).

Example 5. The taxpayer has the following items of income and deduction for the taxable year 1970 without regard to any net operating loss deduction:

Gross income (all from business):		
Ordinary	$50,000	
Net section 1201 gain	40,000	
		$90,000
Deductions:		
Capital gains deduction	20,000	
Medical expenses ($4,100 actually paid but allowable only to the extent in excess of 3 percent of adjusted gross income of $70,000)	2,000	
Other itemized deductions	40,000	
		62,000
Taxable income (before net operating loss deduction)		28,000

In addition, the taxpayer has an item of tax preference of $35,000 resulting from qualified stock options. In 1973, the taxpayer has a net operating loss of $60,000 (no portion of which is attributable to excess tax preferences pursuant to §1.56A–2) which is carried back to 1970 resulting in no taxable income in 1970. In order to determine the amount of the 1973 net operating loss which remains as a carryover to 1971, the 1970 taxable income is redetermined, in accordance with section 172(b)(2) and the regulations thereunder, as follows:

Gross income		$90,000
Deductions:		
Capital gains deduction disallowed.		
Medical expenses ($4,100 actually paid but allowable only to the extent in excess of 3 percent of adjusted gross income of $90,000)	$1,400	
Other itemized deductions	40,000	
		$41,400
Taxable income for section 172(b)(2)		48,600

The limitation on the amount treated as items of tax preference is computed as follows:

Items of tax preference:	
Capital gains	$20,000
Stock options	35,000
	55,000
Less:	
Lesser of capital gains deduction ($20,000) or amount of reduction in carryover due to its disallowance ($20,600)	(20,000)
Limitation	35,000

Thus, the minimum tax for 1970 under section 56 would be 10 percent of $5,000 (items of tax preference of $35,000 less the minimum tax exemption of $30,000).

Example 6. Assume the same facts as in example (5) except that the 1973 net operating loss was $45,000. In this case, the $20,600 increase in the 1970 taxable income as redetermined, results in a decrease of $17,000 (*i.e.*, the remaining 1973 net operating loss after an initial decrease of $28,000 resulting from the 1970 taxable income before redetermination). The limitation on the amount treated as items of tax preference is computed as follows:

Items of tax preference computed without regard to this section	$55,000
Less: Lesser of capital gains deduction ($20,000) or amount of reduction in carryover due to its disallowance ($17,000)	(17,000)
Limitation	38,000

Thus, the minimum tax for 1970 under section 56 would be 10 percent of $8,000 (items of tax preference of $38,000 less the minimum tax exemption of $30,000).

Example 7. The taxpayer has the following items of income and deduction for 1973 without regard to any net operating loss deduction:

Gross income (all from business):		
Ordinary	$100,000	
Net section 1201 gains	120,000	
		$220,000
Deductions:		
Items of tax preference:		
Excess amortization of certified pollution control facilities	45,000	
Capital gains deduction	60,000	
	105,000	
Other business deductions	75,000	
		$180,000
Taxable income (before net operating loss deduction)		40,000

In 1972, the taxpayer had a net operating loss of $70,000 which is carried forward to 1973; $20,000 of this net operating loss is attributable to excess tax preferences. In order to determine the amount of the 1972 net operating loss which remains as a carryover to 1974, the 1973 taxable income is redetermined, in accordance with section 172(b)(2) and the regulations thereunder, as follows:

Gross income	$220,000
Deductions:	
Capital gains deduction	Disallowed
Business deductions	120,000
Taxable income per section 172(b)(2)	100,000

In this case, the $60,000 increase in the 1972 taxable income as redetermined and the $30,000 decrease in the amount of the 1973 net operating loss remaining as a carryover to 1974 (*i.e.*, the remaining 1972 net operating loss after an initial decrease of $40,000 resulting from the 1973 taxable income before redetermination) is entirely attributable to the disallowance of the capital gains deduction. The limitation on the amount treated as items of tax preference is computed as follows:

Items of tax preference computed without regard to this section:	
Capital gains	$60,000
Excess amortization of certified pollution control facilities	45,000
	105,000
Less: Lesser of capital gains deduction (60,000) or amount of reduction in carryover due to its disallowance ($30,000)	(30,000)
	75,000
Plus: Amount of reduction of carryover (due to disallowance of capital gains deduction) attributable to excess tax preferences	20,000
Limitation	95,000

[T.D. 7564, 43 FR 40476, Sept. 12, 1978, as amended by T.D. 8138, 52 FR 15309, Apr. 28, 1987]

§ 1.57–5 Records to be kept.

(a) *In general*. The taxpayer shall have available permanent records of all the facts necessary to determine with reasonable accuracy the amounts described in § 1.57–1. Such records shall include:

(1) In the case of amounts described in paragraph (a) of § 1.57–1: the amount and nature of indebtedness outstanding for the taxable year and the date or dates on which each such indebtedness was incurred or renewed in any form; the amount expended for property held for investment during any taxable year during which such indebtedness was incurred or renewed; and the manner in which it was determined that property was or was not held for investment.

(2) In the case of amounts described in paragraphs (b), (c), (d), (e), and (h) of § 1.57–1:

(i) The dates, and manner in which, the property was acquired and placed in service,

(ii) The taxpayer's basis on the date the property was acquired and the manner in which the basis was determined,

(iii) An estimate of the useful life (in terms of months, hours of use, etc., whichever is appropriate) of the property on the date placed in service or an estimate of the number of units to be produced by the property on the date the property is placed in service, whichever is appropriate, and the manner in which such estimate was determined,

(iv) The amount and date of all adjustments by the taxpayer to the basis of the property and an explanation of the nature of such adjustments, and

(v) In the case of property which has an adjusted basis reflecting adjustments taken by another taxpayer with respect to the property or taken by the taxpayer with respect to other property, the information described in paragraph (a)(2)(i) through (iv) of this section, with respect to such other property or other taxpayer.

(3) In the case of amounts described in paragraph (f) of §1.57–1, the fair market value of the shares of stock at the date of exercise of the option and the option price and the manner in which each was determined.

(4) In the case of amounts described in paragraph (g) of §1.57–1, the amount of debts written off and the amount of the loans outstanding for the taxable year and the 5 preceding taxable years or such shorter or longer period as is appropriate.

(b) *Net operating losses.* The taxpayer shall have available permanent records for the first taxable year in which a portion of a net operating loss was attributable to items of tax preference (within the meaning of §1.56A–2 (b)) and each succeeding taxable year in which there is a net operating loss or a net operating loss carryover a portion of which is so attributable. Such records shall include all the facts necessary to determine with reasonable accuracy the amount of deferred tax liability under section 56, including the amount of the net operating loss in each taxable year in which there are items of tax preference in excess of the minimum tax exemption (as determined under §1.58–1), the amount of the items of tax preference for each such taxable year, the amount by which each such net operating loss reduces taxable income in any taxable year, and the amount by which each such net operating loss is reduced in any taxable year.

[T.D. 7564, 43 FR 40479, Sept. 12, 1978, as amended by T.D. 8138, 52 FR 15309, Apr. 28, 1987]

§ 1.58–1 Minimum tax exemption.

(a) *In general.* For purposes of the minimum tax for tax preferences (subtitle A, chapter 1A, part VI), the minimum tax exemption is $30,000 except as otherwise provided in this section.

(b) *Husband and wife.* In the case of a married individual filing a separate return, section 58(a) provides that the minimum tax exemption is $15,000. This rule applies without regard to whether the married individual is living together with or apart from his spouse and without regard to whether or not his spouse has any items of tax preference.

(c) *Members of controlled groups*—(1) *Amount of exemption*—(i) *General rule.* Under section 58(b), if a corporation is a component member of a controlled group of corporations on December 31 (as defined in section 1563 (a) and (b) and the regulations thereunder), the minimum tax exemption for such taxable year which includes such December 31 is an amount equal to—

(*a*) $30,000 divided by the number of corporations which are component members of such group on December 31, or

(*b*) If an apportionment plan is adopted under subparagraph (3) of this paragraph, such portion of the $30,000 as is apportioned to such member in accordance with such plan.

(ii) *Consolidated returns.* The minimum tax exemption of a controlled group all of whose component members join in the filing of a consolidated return is $30,000. If there are component members of the controlled group which do not join in the filing of a consolidated return, and there is no apportionment plan effective under subparagraph (3) of this paragraph apportioning the $30,000 among the component members filing the consolidated return and the other component members of the controlled group, each component member of the controlled group (including each component member which joins in filing the consolidated return) is treated as a separate corporation for purposes of equally apportioning the $30,000 amount under subdivision (i)(*a*) of this subparagraph. In such case, the minimum tax exemption of the corporations filing the consolidated return is the sum of the amounts apportioned to each component member which joins in the filing of the consolidated return.

(2) *Certain short taxable years.* If the return of a corporation is for a short

period which does not include a December 31, and such corporation is a component member of a controlled group of corporations with respect to such short period, the minimum tax exemption of such corporation for such short period is an amount equal to $30,000 divided by the number of corporations which are component members of such group on the last day of such short period. The minimum tax exemption so determined is also subject to the rules of section 443(d) (relating to reduction in the amount of the exemption for short periods) and the regulations thereunder. For purposes of this subparagraph, the term ''short period'' does not include any period if the income for such period is required to be included in a consolidated return under §1.1502–76(b). The determination of whether a corporation is a component member of a controlled group of corporations on the last day of a short period is made by applying the definition of ''component member'' contained in section 1563(b) and §1.1563–1 as if the last day of such short period were a December 31.

(3) *Apportionment of minimum tax exemption*—(i) *Apportionment plan*—(*a*) *In general.* In the case of corporations which are component members of a controlled group of corporations on a December 31, a single minimum tax exemption may be apportioned among such members if all such members consent, in the manner provided in subdivision (ii) of this subparagraph, to an apportionment plan with respect to such December 31. Such plan must provide for the apportionment of a fixed dollar amount to one or more of such members, but in no event may the sum of the amount so apportioned exceed $30,000. An apportionment plan is not considered as adopted with respect to a particular December 31 until each component member which is required to consent to the plan under subdivision (ii)(*a*) of this subparagraph files the original of a statement described in such subdivision (or, the original of a statement incorporating its consent is filed on its behalf). In the case of a return filed before a plan is adopted, the minimum tax exemption for purposes of such return is to be equally apportioned in accordance with subparagraph (1) of this paragraph. If a valid apportionment plan is adopted after the return is filed and within the time prescribed in (*b*) of this subdivision (i), such return must be amended (or a claim for refund should be made) to reflect the change from equal apportionment.

(*b*) *Time for adopting plan.* A controlled group may adopt an apportionment plan with respect to a particular December 31 only if, at the time such plan is sought to be adopted, there is at least 1 year remaining in the statutory period (including any extensions thereof) for the assessment of the deficiency against any corporation the tax liability of which would be increased by the adoption of such plan. If there is less than 1 year remaining with respect to any such corporation, the district director or the director of the service center with whom such corporation files its income tax return will ordinarily, upon request, enter into an agreement to extend such statutory period for the limited purpose of assessing any deficiency against such corporation attributable to the adoption of such apportionment plan.

(*c*) *Years for which effective.* (*1*) The amount apportioned to a component member of a controlled group of corporations in an apportionment plan adopted with respect to a particular December 31 constitutes such member's minimum tax exemption for its taxable year including the particular December 31, and for all taxable years including succeeding December 31's, unless the apportionment plan is amended in accordance with subdivision (iii) of this subparagraph or is terminated under paragraph (*c*)(*2*) of this subdivision (i). Thus, the apportionment plan (including any amendments thereof) has a continuing effect and need not be renewed annually.

(*2*) If an apportionment plan is adopted with respect to a particular December 31, such plan terminates with respect to a succeeding December 31, if: the controlled group goes out of existence with respect to such succeeding December 31 within the meaning of paragraph (b) of §1.1562–5, any corporation which was a component member of such group on the particular December 31 is not a component member of such group on such succeeding December 31, or any corporation which was not a component member of such group on the particular December 31 is a component member of such group on such succeeding December 31. An apportionment plan, once terminated with respect to a December 31, is no longer effective. Accordingly, unless a new apportionment plan is adopted, the minimum tax exemption of the component members of the controlled group for their taxable years which include such December 31 and all December 31's thereafter will be determined under subparagraph (1) of this paragraph.

(*3*) If an apportionment plan is terminated with respect to a particular December 31 by reason of the addition or withdrawal of a component member, each corporation which is a component member of the controlled group on such particular December 31 must, on or before the date it files its income tax return for the taxable year which includes such particular December 31, notify the district director or the director of the service center with whom it files such return to such termination. If an apportionment plan is terminated with respect to a particular December 31 by reason of the controlled group going out of existence, each corporation which was a component member of the controlled group on the preceding December 31 must, on or before the date it files its income tax return for the taxable year which includes such particular December 31, notify the district director or the director of the service center with whom it files such return to such termination.

(ii) *Consents to plan*—(*a*) *General rule.* (*1*) The consent of a component member (other than a wholly-owned subsidiary) to an apportionment plan with respect to a particular December 31 is to be made by means of a statement, signed by any person who is duly authorized to act on behalf of the consenting member, stating that such member consents to the apportionment plan with respect to such December 31. The statement must set forth the name, address, taxpayer identification number, and taxable year of the consenting component member, the amount apportioned to such member under the plan, and the internal revenue district or service center where the original of the statement is to be filed. The consent of more than one component member may be incorporated in a single statement. The original of a statement of consent is to be filed with the district director or the director of the service center with whom the component member of the group on such December 31 which has the taxable year ending first on or after such date filed its return for such taxable year. If two or more component members have the same such taxable year, a statement of consent may be filed with the district director or the director of the service center with whom the return for any such taxable year is filed. The original of a statement of consent is to have attached thereto information (referred to in this subdivision as ''group identification'') setting forth the name, address, taxpayer identification number, and taxable year of each component member of the controlled group on such December 31 (including wholly-owned subsidiaries) and the amount apportioned to each such member under the plan. If more than one original statement is filed, a statement may incorporate the group identification by reference to the name, address, taxpayer identification number, and taxable year of the component member of the group which has attached such group identification to the original of its statement.

(*2*) Each component member of the group on such December 31 (other than wholly-owned subsidiaries) must attach a copy of its consent (or a copy of the statement incorporating its consent) to the income tax return, amended return, or claim for refund filed with its district director or director of the service center for the taxable year including such date. Such copy must either have attached thereto information on group identification or must incorporate such information by reference to the name, address, taxpayer identification number, and taxable year of the component member of the group which has attached such information to its income tax return, amended return, or claim for refund filed with the same district director or director of the service center for the taxable year including such date.

(*b*) *Wholly-owned subsidiaries*. (*1*) Each component member of a controlled group which is a wholly-owned subsidiary of such group with respect to a December 31 is deemed to consent to an apportionment plan with respect to such December 31, provided each component member of the group which is not a wholly-owned subsidiary consents to the plan. For purposes of this paragraph, a component member of a controlled group is considered to be a wholly-owned subsidiary of the group with respect to a December 31, if, on each day preceding such date and during its taxable year which includes such date, all of its stock is owned directly by one or more corporations which are component members of the group on such December 31.

(*2*) Each wholly-owned subsidiary of a controlled group with respect to a December 31 must attach a statement containing the information which is required to be set forth in a statement of consent to an apportionment plan with respect to such December 31 to the income tax return, amended return, or claim for refund filed with its district director or director of the service center for the taxable year which includes such date. Such statement must either have attached thereto information on group identification or incorporate such information by reference to the name, address, taxpayer identification number, and taxable year of a component member of the group which has attached such information to its income tax return, amended return, or claim for refund filed with the same district director or director of the service center for the taxable year including such date.

(iii) *Amendment of plan*. An apportionment plan adopted with respect to a December 31 by a controlled group of corporations may be amended with respect to such December 31 or with respect to any succeeding December 31 for which the plan is effective under subdivision (i)(*c*) of this subparagraph. An apportionment plan must be amended with respect to a particular December 31 and the amendments to the plan are effective only if adopted in accordance with the rules prescribed in this paragraph for the adoption of an original plan with respect to such December 31.

(iv) *Component members filing consolidated return*. If the component members of a controlled group of corporations on a December 31 include corporations which join the filing of a consolidated return, the corporations filing the consolidated return are treated as a single component member for purposes of this subparagraph. Thus, for example, only one consent executed by the common parent to an apportionment plan filed pursuant to this section is required on behalf of the component members filing the consolidated return.

(d) *Estates and trusts*. Section 58(c)(2) provides that, in the case of an estate or trust, the minimum tax exemption applicable to such estate or trust is an amount which bears the same ratio to $30,000 as the portion of the sum of the items of tax preference apportioned to the estate or trust bears to the full sum before apportionment. For example, if one-third of the sum of the items of tax preference of a trust are subject to tax at the trust level after apportionment under section 58(c)(1) and §1.58–3, the trust's minimum tax exemption is $10,000. See §1.58–3 for rules with respect to the apportionment of items of tax preference of an estate or trust.

(e) *Short taxable year*. See section 443(d) and §1.443–1(d) with respect to reduction in the amount of the minimum tax exemption in the case of a short taxable year.

[T.D. 7564, 43 FR 40479, Sept. 12, 1978]

§ 1.58–2 General rules for conduit entities; partnerships and partners.

(a) *General rules for conduit entities*. Sections 1.58–3 through 1.58–6 provide rules under which items of tax preference of an estate, trust, electing small business corporation, common trust fund, regulated investment company, or real estate investment trust (referred to in this paragraph as the ''conduit entity'') are treated as items of tax preference of the beneficiaries, shareholders, participants, etc. (referred to in this paragraph as the ''distributees''). Where an item of tax preference of a conduit entity is so apportioned to a distributee, the item of tax preference retains its character in the hands of the distributee and is adjusted to reflect:

(1) The separate items of income and deduction of the distributee and (2) the tax status of the distributee as an individual, corporation, etc. For example, if a trust has $100,000 of capital gains for the taxable year, all of which are distributed to A, an individual, the item of tax preference apportioned to A under section 57(a)(9) (and §1.57–1(i)(1)) is $50,000. If, however, A had a net capital loss for the taxable year of $60,000 without regard to the distribution from the trust, the trust tax preference would be adjusted in the hands of A to reflect the separate items of income and deduction passed through to the distributee, or, in this case, to reflect the net section 1201 gain to A of $40,000. Thus, A's capital gains items of tax preference would be $20,000. By application of this rule, A, in effect, treats capital gains distributed to him from the trust the same as his other capital gains in computing his capital gains item of tax preference. If A had been a corporation, the trust tax preference would be adjusted both to reflect the capital loss and to reflect A's tax status by recomputing the capital gains item of tax preference (after adjustment for the capital loss) under section 57(a)(9)(B) and §1.57–1(i)(2). Similarly, if depreciation on section 1245 property subject to a net lease (as defined in section 57(a)(3) and §1.57–1(c)) is apportioned from a conduit entity to a corporation (other than a personal holding company or electing small business corporation), the amount so apportioned to the corporation is not treated as an item of tax preference to such corporation since such item is not an item of tax preference in the case of a corporation (other than a personal holding company or an electing small business corporation).

(b) *Partnerships and partners.* (1) Section 701 provides that a partnership as such is not subject to the income tax imposed by chapter 1. Thus, a partnership as such is not subject to the minimum tax for tax preferences. Section 702 provides that, in determining his income tax, each partner is to take into account separately his distributive share of certain items of income, deductions, etc. of the partnership and other items of income, gain, loss, deduction, or credit of the partnership to the extent provided by regulations prescribed by the Secretary or his delegate. Accordingly, each partner, in computing his items of tax preference, must take into account separately those items of income and deduction of the partnership which enter into the computation of the items of tax preference in accordance with subparagraph (2) of this paragraph.

(2) Pursuant to section 702, each partner must, solely for purposes of the minimum tax for tax preferences (to the extent not otherwise required to be taken into account separately under section 702 and the regulations thereunder), take into account separately in the manner provided in subchapter K and the regulations thereunder those items of income and deduction of the partnership which enter into the computation of the items of tax preference specified in section 57 and the regulations thereunder. A partner must, for this purpose, take into account separately his distributive share of:

(i) Investment interest expense (as defined in section 57(b)(2)(D) determined at the partnership level;

(ii) Investment income (as defined in section 57(b)(2)(B) determined at the partnership level;

(iii) Investment expenses (as defined in section 57(b)(2)(C)) determined at the partnership level;

(iv) With respect to each section 1250 property (as defined in section 1250(c)), the amount of the deduction allowable for the taxable year for exhaustion, wear and tear, obsolescence, or amortization and the deduction which would have been allowable for the taxable year had the property been depreciated under the straight line method each taxable year of its useful life (determined without regard to section 167(k)) for which the partnership has held the property;

(v) With respect to each item of section 1245 property (as defined in section 1245(a)(3)) which is subject to a net lease, the amount of the deduction allowable for exhaustion, wear and tear, obsolescence, or amortization and the deduction which would have been allowable for the taxable year had the property been depreciated under the straight line method for each taxable year of its useful life for which the partnership has held the property;

(vi) With respect to each certified pollution control facility for which an election is in effect under section 169, the amount of the deduction allowable for the taxable year under such section and the deduction which would have been allowable under section 167 had no election been in effect under section 169;

(vii) With respect to each unit of railroad rolling stock for which an election is in effect under section 184, the amount of the deduction allowable for the taxable year under such section and the deduction which would have been allowable under section 167 had no election been in effect under section 184;

(viii) In the case of a partnership which is a financial institution to which section 585 or 593 applies, the amount of the deduction allowable for the taxable year for a reasonable addition to a reserve for bad debts and the amount of the deduction that would have been allowable for the taxable year had the institution maintained its bad debt reserve for all taxable years on the basis of actual experience; and

(ix) With respect to each mineral property, the deduction for depletion allowable under section 611 for the taxable year and the adjusted basis of the property at the end of the taxable year (determined without regard to the depreciation deduction for the taxable year).

If, pursuant to section 743 (relating to optional adjustment to basis), the basis of partnership property is adjusted with respect to a transferee partner due to an election being in effect under section 754 (relating to manner of electing optional adjustment), items representing amortization, depreciation, depletion, gain or loss, and the adjusted basis of property subject to depletion, described above, shall be adjusted to reflect the basis adjustment under section 743.

(3) The minimum tax is effective for taxable years ending after December 31, 1969. Thus, subparagraph (2) of this paragraph is inapplicable in the case of items of income or deduction paid or accrued in a partnership's taxable year ending on or before December 31, 1969.

[T.D. 7564, 43 FR 40481, Sept. 12, 1978]

§ 1.58–3 Estates and trusts.

(a) *In general.* (1) Section 58(c)(1) provides that the sum of the items of tax preference of an estate or trust shall be apportioned between the estate or trust and the beneficiary on the basis of the income of the estate or trust allocable to each. Income for this purpose is the income received or accrued by the trust or estate which is not subject to current taxation either in the hands of the trust or estate or the beneficiary by reason of an item of tax preference. The character of the amounts distributed is determined under section 652(b) or 662(b) and the regulations thereunder.

(2) Additional computations required by reason of excess distributions are to be made in accordance with the principles of sections 665 through 669 and the regulations thereunder.

(3) In the case of a charitable remainder annuity trust (as defined in section 664(d)(1) and §1.664–2) or a charitable remainder unitrust (as defined in section 664(d)(2) and §1.664–3), the determination of the income not subject to current taxation by reason of an item of tax preference is to be made as if such trust were generally subject to taxation. Where income of such a trust is not subject to current taxation in accordance with this section and is distributed to a beneficiary in a taxable year subsequent to the taxable year in which the trust received or accrued such income, the items of tax preference relating to such income are apportioned to the beneficiary in such subsequent year (without credit for minimum tax paid by the trust with respect to items of tax preference which are subject to the minimum tax by reason of section 664(c)).

(4) Items of tax preference apportioned to a beneficiary pursuant to this section are to be taken into account by the beneficiary in his taxable year within or with which ends the taxable year of the estate or trust during which it has such items of tax preference.

(5) Where a trust or estate has items of income or deduction which enter

into the computation of the excess investment interest item of tax preference, but such items do not result in an item of tax preference at the trust or estate level, each beneficiary must take into account, in computing his excess investment interest, the portion of such items distributed to him. The determination of the portion of such items distributed to each beneficiary is made in accordance with the character rules of section 652(b) or 662(b) and the regulations thereunder.

(6) Where, pursuant to subpart E of part 1 of subchapter J (sections 671 through 678), the grantor of a trust or another person is treated as the owner of any portion of the trust, there shall be included in computing the items of tax preference of such person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent such items are taken into account under section 671 and the regulations thereunder. Any remaining portion of the trust is subject to the provisions of this section.

(b) *Examples*. The principles of this section may be illustrated by the following examples in each of which it is assumed that none of the distributions are accumulation distributions (see sections 665 through 669 and the regulations thereunder):

Example 1. Trust A, with one income beneficiary, has the following items of income and deduction without regard to the deduction for distributions:

Income:	
Business income	$200,000
Investment income	20,000
	220,000
Deductions:	
Business deductions (nonpreference)	100,000
Investment interest expense	80,000
	180,000

Based on the above figures, the trust has $100,000 of taxable income without regard to items which enter into the computation of excess investment interest and the deduction for distributions. The trust also has $60,000 of excess investment interests, resulting in $40,000 of distributable net income. Thus, $60,000 of the $100,000 of noninvestment income is not subject to current taxation by reason of the excess investment interest.

(*a*) If $40,000 is distributed to the beneficiary, the beneficiary will normally be subject to tax on the full amount received and the ''sheltered'' portion of the income will remain at the trust level. Thus, none of the excess investment interest item of tax preference is apportioned to the beneficiary.

(*b*) If the beneficiary receives $65,000 from the trust, the beneficiary is still subject to tax on only $40,000 (the amount of the distributable net income) and thus, is considered to have received $25,000 of business income ''sheltered'' by excess investment interest. Thus, $25,000 of the $60,000 of excess investment interest of the trust is apportioned to the beneficiary.

Example 2. Trust B has $150,000 of net section 1201 gain.

(*a*) If none of the gain is distributed to the beneficiaries, none of the capital gains item of tax preference is apportioned to the beneficiaries.

(*b*) If all or a part of the gain is distributed to the beneficiaries, a proportionate part of the capital gains item of tax preference is apportioned to the beneficiaries. If any of the beneficiaries are corporations the capital gains item of tax preference is adjusted in the hands of the corporations as provided in § 1.58–2(a).

Example 3. Trust C has taxable income of $200,000 computed without regard to depreciation on section 1250 property and the deduction for distributions. The depreciation on section 1250 property held by the trust is $160,000. The trust instrument provides for income to be retained by the trust in an amount equal to the depreciation on the property determined under the straight line method (which method has been used for this purpose for the entire period the trust has held the property) which, in this case is equal to $100,000. The $60,000 excess of the accelerated depreciation of $160,000 over the straight line amount which would have resulted had the property been depreciated under that method for the entire period for which the trust has held the property is an item of tax preference pursuant to section 57(a)(2). Of the remaining $100,000 of net income of the trust (after the reserve for depreciation), 80 percent is distributed to the beneficiaries. Pursuant to sections 167(h) and 642(e), 80 percent of the remaining $60,000 of depreciation deduction (or $48,000) is taken as a deduction directly by the beneficiaries and ''shelters'' the income received by the beneficiaries. Thus, the full $48,000 deduction taken by the beneficiaries is ''excess accelerated depreciation'' on section 1250 property and is an item of tax preference in the hands of the beneficiaries. None of the remaining $12,000 of ''excess accelerated depreciation'' is apportioned to the beneficiaries since this amount ''shelters'' income retained at the trust level.

Example 4. G creates a trust the ordinary income of which is payable to his adult son.

Ten years from the date of the transfer, corpus is to revert to G. G retains no other right or power which would cause him to be treated as an owner under subpart E of part 1 of subchapter J (section 671 and following). Under the terms of the trust instrument and applicable local law capital gains must be applied to corpus. During the taxable year 1970 the trust has $200,000 income from dividends and interest and a net long-term capital gain of $100,000. Since the capital gain is held or accumulated for future distribution to G, he is treated under section 677(a)(2) as an owner of a portion of the trust to which the gain is attributable. Therefore, he must include the capital gain in the computation of his taxable income in 1970 and the capital gain item of tax preference is treated as being directly received by G. Accordingly, no adjustment is made to the trust's minimum tax exemption by reason of the capital gain.

Example 5. For its taxable year 1971 the trust referred to in example (4) has taxable income of $200,000 computed without regard to depreciation on section 1250 property and the deduction for distributions. The depreciation on section 1250 property held by the trust is $160,000. The trust instrument provides for income to be retained by the trust in an amount equal to the depreciation on the property determined for purposes of the Federal income tax. If the property had been depreciated under the straight line method for the entire period for which the trust held the property the resulting depreciation deduction would have been $100,000. The $60,000 excess is, therefore, an item of tax preference pursuant to section 57(a)(2) and §1.57–1(d). Since this amount of "income" is held or accumulated for future distributions to G, he is treated under section 677(a)(2) as an owner of a portion of the trust to which such income is attributable. Therefore, section 671 requires that in computing the tax liability of the grantor the income, deductions, and credits against tax of the trust which are attributable to such portion shall be taken into account. Thus, the grantor has received $160,000 of income and is entitled to a depreciation deduction in the same amount. The $60,000 item of tax preference resulting from the excess depreciation is treated as being directly received by G as he has directly received the income sheltered by that preference. Accordingly, no adjustment is made to the trust's minimum tax exemption by reason of such depreciation.

[T.D. 7564, 43 FR 40482, Sept. 12, 1978]

§ 1.58–3T Treatment of non-alternative tax itemized deductions by trusts and estates and their beneficiaries in taxable years beginning after December 31, 1982 (temporary).

For purposes of section 58(c), in taxable years beginning after December 31, 1982, itemized deductions of a trust or estate which are not alternative tax itemized deductions (as defined in section 55(e)(1)), shall be treated as items of tax preference and apportioned between trusts and their beneficiaries, and estates and their beneficiaries.

[T.D. 8083, 51 FR 15320, Apr. 23, 1986]

§ 1.58–4 Electing small business corporations.

(a) *In general.* Section 58(d)(1) provides rules for the apportionment of the items of tax preference of an electing small business corporation among the shareholders of such corporation. Section 58(d)(2) provides rules for the imposition of the minimum tax on an electing small business corporation with respect to certain capital gains. For purposes of section 58(d) and this section, the items of tax preference are computed at the corporate level as if section 57 generally applied to the corporation. However, the items of tax preference so computed are treated as items of tax preference of the shareholders of such corporation and not as items of tax preference of such corporation (except as provided in paragraph (c) of this section). The items of tax preference specified in section 57(a)(1) and §1.57–1(a) (excess investment interest) and section 57(a)(3) and §1.57–1(c) (accelerated depreciation on section 1245 property subject to a net lease), while generally inapplicable to corporations, are included as items of tax preference in the case of an electing small business corporation.

(b) *Apportionment to shareholders.* (1) The items of tax preference of an electing small business corporation, other than the capital gains item of tax preference described in paragraph (c) of this section, are apportioned pro rata among the shareholders of such corporation in a manner consistent with section 1374(c)(1). Thus, with respect to the items of tax preference of the electing small business corporation, there is to be treated as items of tax preference of each shareholder a pro rata share of such items computed as follows:

(i) Divide the total amount of such items of tax preference of the corporation by the number of days in the taxable year of the corporation, thus determining the daily amount of such items of tax preference.

(ii) Determine for each day the shareholder's portion of the daily amount of each such item of tax preference by applying to such amount the ratio which the stock owned by the shareholder on that day bears to the total stock outstanding on that day.

(iii) Total the shareholder's daily portions of each such item of tax preference of the corporation for it taxable year.

Amounts taken into account by shareholders in accordance with this paragraph are considered to consist of a pro rata share of each item of tax preference of the corporation. Thus, for example, if the corporation has $50,000 of excess investment interest and $150,000 of excess accelerated depreciation on section 1250 property and a shareholder, in accordance with this paragraph, takes into account $60,000 of the total $200,000 of tax preference items of the corporation, one-fourth ($50,000 ÷ $200,000) of the $60,000, or $15,000, taken into account by the shareholder is considered excess investment interest and three-fourths of the $60,000, or $45,000, is considered excess accelerated depreciation on section 1250 property.

(2) Items of tax preference apportioned to a shareholder pursuant to subparagraph (1) of this paragraph are taken into account by the shareholder for the shareholder's taxable year in which or with which the taxable year of the corporation ends, except that, in the case of the death of a shareholder during any taxable year of the corporation (during which the corporation is an electing small business corporation), the items of tax preference of the corporation for such taxable year are taken into account for the final taxable year of the shareholder.

(c) *Capital gains.* (1) Capital gains of an electing small business corporation, other than those capital gains subject to tax under section 1378, do not result in an item of tax preference at the corporate level since, in applying the formula specified in sections 57(a)(9)(B) and §1.57–1(i)(2), the rate of tax on capital gains (and the resulting tax) at the corporate level is zero. Under section 1375 (a) shareholders of an electing small business corporation take into account the capital gains of the corporation (including capital gains subject to tax under section 1378). Therefore, the computation of the capital gains item of tax preference at the shareholder level, with respect to such capital gains, is taken into account automatically by operation of section 57(a)(9) and §1.57–1(i). To avoid double inclusion of the capital gains item of tax preference by a shareholder with respect to capital gains subject to tax under section 1378, the capital gains item of tax preference which results at the corporate level by reason of section 58 (d)(2) is not treated under section 58 (d)(1) as an item of tax preference of the shareholders of the corporation.

(2) The capital gains item of tax preference of an electing small business corporation subject to the tax imposed by section 1378 is the excess of the amount of tax computed under section 1378(b)(2) over the sum of—

(i) The amount of tax that would be computed under section 1378(b)(2) if the following amount were excluded:

(*a*) That portion of the net section 1201 gain of the corporation described in section 1378(b)(1), or

(*b*) If section 1378(c)(3) applies, that portion of the net section 1201 gain attributable to the property described in section 1378(c)(3), and

(ii) The amount of tax imposed under section 1378 divided by the sum of the normal tax rate and the surtax rate under section 11 for the taxable year.

(3) The principles of this paragraph may be illustrated by the following example.

Example. Corporation X is a calendar year taxpayer and an electing small business corporation. For its taxable year 1971 the corporation has net section 1201 gain of $650,000 and taxable income of $800,000 (including the net section 1201 gain). Although X's election under section 1372(a) has been in effect for its three immediately preceding taxable years, X is subject to the tax imposed by section 1378 for 1971 since it has net section 1201 gain (in the amount of $200,000) attributable to property with a substituted basis. The tax computed under section 1378(b)(1) is $187,500 (30 percent of ($650,000 minus $25,000)) and under section 1378(b)(2) is $377,500 (22 percent of $800,000 plus 26 percent of $775,000). By reason of the limitation imposed by section 1378(c) the tax actually imposed by section 1378 is $60,000 (30 percent of $200,000, the net section 1201 gain). The tax computed under section 1378(b)(2) with the modification required under subparagraph (2)(i) of this paragraph is $281,500 (22 percent of $600,000 plus 26 percent of $575,000). Thus, the 1971 capital gains item of tax preference X is $75,000 computed as follows:

1. Tax computed under 1378(b) (2)	$377,500
2. Tax computed under 1378(b) (2) with modification	281,500
3. Excess	96,000
4. Tax actually imposed under 1378	60,000
5. Difference	36,000
6. Normal tax rate plus surtax rate	.48
7. Tax preference (line 5 divided by line 6)	$75,000

In addition each shareholder of X will take into account his distributive share of the $650,000 of net section 1201 gain of X less the taxes paid by X under sections 56 and 1378 on the gain

[T.D. 7564, 43 FR 40483, Sept. 12, 1978]

§ 1.58–5 Common trust funds.

Section 58(e) provides that each participant in a common trust fund (as defined in section 584 and the regulations thereunder) is to treat as items of tax preference his proportionate share of the items of tax preference of the fund computed as if the fund were an individual subject to the minimum tax. The participant's proportionate share of the items of tax preference of the fund is determined as if the participant had realized, or incurred, his pro rata share of items of income, gain, loss, or deduction of the fund directly from the source from which realized or incurred by the fund. The participant's pro rata share of such items is determined in a manner consistent with section 1.584–2(c). Items of tax preference apportioned to a participant pursuant to this paragraph are taken into account by the participant for the participant's taxable year in which or with which the taxable year of the trust ends.

[T.D. 7564, 43 FR 40484, Sept. 12, 1978]

§ 1.58–6 Regulated investment companies; real estate investment trusts.

(a) *In general.* Section 58(f) provides rules with respect to the determination of the items of tax preference of regulated investment companies (as defined in section 851) and their shareholders and real estate investment trusts (as defined in section 856) and their shareholders, or holders of beneficial interest. In general, the items of tax preference of such companies and such trusts are determined at the company or trust level and the items of tax preference so determined (other than the capital gains item of tax preference (sections 57(a)(9) and § 1.57–1(i)) and, in the case of a real estate investment trust, accelerated depreciation on section 1250 property (sections 57(a)(2) and § 1.57–1(b)) are treated as items of tax preference of the shareholders, or holders of beneficial interest, in the same proportion that the dividends (other than capital gains dividends) paid to each such shareholder, or holder of beneficial interest, bear to the taxable income of such company or such trust determined without regard to the deduction for dividends paid. In no case, however, is such proportion to be considered in excess of 100 percent. For example, if a regulated investment company has items of tax preference of $500,000 for the taxable year, none of which resulted from capital gains, and distributes dividends in an amount equal to 90 percent of its taxable income, each shareholder treats his share of 90 percent of the company's items of tax preference, or (a proportionate share of) $450,000, as items of tax preference of the shareholder. The remaining $50,000 constitutes items of tax preference of the company. Amounts treated under this paragraph as items of tax preference of the shareholders, or holders of beneficial interest, are deemed to be derived proportionately from each item of tax preference of the company or trust, other than the capital gains item of tax preference and, in the case of a real estate investment trust, accelerated depreciation on section 1250 property. Such amounts are taken into account by the shareholders, or holders of beneficial interest, in the same taxable year in which the dividends on which the apportionment is based are includible in income. The minimum tax exemption of the trust or company shall not be reduced because a portion of the trust's or company's items of tax preference are allocated to the shareholders or holders of beneficial interests.

(b) *Capital gains.* Section 58(g)(1) provides that a regulated investment company or real estate investment trust does not treat as an item of tax preference the capital gains item of tax preference under section 57(a)(9) (and §1.57–1(i)) to the extent that such item is attributable to amounts taken into income by the shareholders of such company under section 852(b)(3) or by the shareholders or holders of beneficial interest of such trust under section 857(b)(3). Thus, such a company or trust computes its capital gains item of tax preference on the basis of its net section 1201 gain less the sum of (1) the capital gains dividend (as defined in section 852(b)(3)(C) or 857(b)(3)(C)) for the taxable year of the company or trust plus (2), in the case of a regulated investment company, that portion of the undistributed capital gains designated, pursuant to section 852(b)(3)(D) and the regulations thereunder, by the company to be includible in the shareholder's return as long-term capital gains for the shareholders's taxable year in which the last day of the company's taxable years falls. Amounts treated under section 852(b)(3) or 857(b)(3) as long-term capital gains of shareholders, or holders of beneficial interest, are automatically included, pursuant to sections 57(a)(9) and 1.57–1(i), in the computation of the capital gains item of tax preference of the shareholders, or holders of beneficial interest.

(c) *Accelerated depreciation on section 1250 property.* In the case of a real estate investment trust, all of the items of tax preference resulting from accelerated depreciation on section 1250 property held by the trust (section 57(a)(2) and §1.57–1(b)) are treated as items of tax preference of the trust, and, thus, none are treated as items of tax preference of the shareholder, or holder of beneficial interest.

[T.D. 7564, 43 FR 40484, Sept. 12, 1978]

§ 1.58–7 Tax preferences attributable to foreign sources; preferences other than capital gains and stock options.

(a) *In general.* Section 58(g)(1) provides that except in the case of the stock options item of tax preference (section 57(a)(6) and §1.57–1(f)) and the capital gains item of tax preference (section 57(a)(9) and §1.57–1(i)), items of tax preference which are attributable to sources within any foreign country or possession of the United States shall, for purposes of section 56, be taken into account only to the extent that such items reduce the tax imposed by chapter 1 (other than the minimum tax under section 56) on income derived from sources within the United States. Items of tax preference from sources within any foreign country or possession of the United States reduce the chapter 1 tax on income from sources within the United States to the extent the deduction relating to such preferences, in combination with other foreign deductions, exceed the income from such sources and, in effect, offset income from sources within the United States. Items of tax preference, for this purpose, are determined after application of §1.57–4 (relating to limitation on amounts treated as items of tax preference). In the case of a taxpayer who deducted foreign taxes under section 164 for a taxable year, the provisions of this section shall be applied (without regard to section 275(a)(4)) as if he had elected the overall foreign tax credit limitation under section 904(a)(2) for such year.

(b) *Preferences attributable to foreign sources*—(1) *Preferences other than excess investment interest.* Except in the case of excess investment interest (see subparagraph (2) of this paragraph), an item of tax preference to which this section applies is attributable to sources within a foreign country or possession of the United States to the extent such item is attributable to a deduction properly allocable or apportionable to an item or class of gross income from sources within a foreign country or possession of the United States under the principles of section 862(b), or section 863, and the regulations thereunder. Where, in the case of income partly from sources within the United States and partly from sources within a foreign country or possession of the United States, taxable income is computed before apportionment to domestic and foreign sources, and is then apportioned by processes or formulas of general apportionment (pursuant to section 863(b) and the regulations thereunder), deductions attributable to such taxable income are considered to be proportionately from sources within the United States and within the foreign country or possession of the United States on the same basis as taxable income.

(2) *Excess investment interest*—(*i*) *Per-country limitation*—(*a*) In the case of a taxpayer on the per-country foreign tax credit limitation under section 904(a) for the taxable year, excess investment interest (as defined in section 57(b)(1)), and the resulting item of tax preference, is attributable to sources within a foreign country or a possession of the United States to the extent that investment interest expense attributable to income from sources within such foreign country or possession of the United States exceeds the net investment income from sources within such foreign country or such possession. For this purpose, net investment income from within a foreign country or possession of the United States is the excess (if any) of the investment income from sources within such country or possession over the investment expenses attributable to income from sources within such country or such possession. For the definition of investment interest expense see section 57(b)(2)(D); for the definition of investment income see section 57(b)(2)(B); for the definition of investment expense see section 57(b)(2)(C).

(*b*) If the taxpayer's excess investment interest computed on a worldwide basis is less than the taxpayer's total separately determined excess investment interest (as defined in this subdivision (*b*)), the amount of the taxpayer's excess investment interest from each foreign country or possession is the amount which bears the same relationship to the taxpayer's excess investment interest from each such country or possession, determined without regard to this subdivision (*b*), as the taxpayer's worldwide excess investment interest bears to the taxpayer's total separately determined excess investment interest. For purposes of this subdivision (*b*), the taxpayer's total separately determined excess investment interest is the sum of the total excess investment interest determined without regard to this subdivision (*b*) plus the taxpayer's excess investment interest from sources within the United States determined in a manner consistent with (*a*) of this subdivision (i).

(ii) *Overall limitation*. In the case of a taxpayer who has elected the overall foreign tax credit limitation under section 904(a)(2) for the taxable year, excess investment interest (as defined in section 57(b)(1)), and the resulting item of tax preference, is attributable to sources within any foreign country or possession of the United States to the extent that investment interest expense attributable to income from such sources exceeds the sum of (*a*) the net investment income from such sources plus (*b*) the excess, if any, of net investment income from sources within the United States over investment interest expense attributable to sources within the United States. For this purpose, net investment income from sources within any foreign country or possession of the United States is the excess (if any) of the investment income from all such sources over the investment expenses attributable to income from such sources. For the definition of investment interest expense see section 57(b)(2)(D) for the definition of investment income see section 57(b)(2)(B); for the definition of investment expense see section 57(b)(2)(C).

(iii) *Allocation of expenses*. The determination of the investment interest expense and investment expenses attributable to a foreign country or possession of the United States is made in a manner consistent with subparagraph (1) of this paragraph.

(iv) *Attribution of certain interest deductions to foreign sources*. Where net investment income from sources within any foreign country or possession has the effect of offsetting investment interest expense attributable to income from sources within the United States, the deductions for the investment interest expense so offset are, for purposes of §1.58–7(c) (relating to reduction in taxes on United States source income), treated as deductions attributable to income from sources within the foreign country or possession from which such net investment income is derived. Such an offset will occur where there is an excess of investment interest expense attributable to income from sources within the United States over net investment income from such sources and (*a*) in the case of a taxpayer on the per-country foreign tax credit limitation, an excess of net investment income from sources within a foreign country or possession of the United States over investment interest expense from within such foreign country or possession, or (*b*) in the case of a taxpayer who has elected the overall foreign tax credit limitation, there is an excess of net investment income from sources within foreign countries or possessions of the United States over investment interest expense attributable to income from within such sources.

(v) *Separate limitation on interest income.* Where a taxpayer has income described in section 904(f)(2) (relating to interest income subject to the separate foreign tax credit limitation) or expenses attributable to such income, the determination of the excess investment interest resulting therefrom must be determined separately with respect to such income and the expenses properly allocable or apportionable thereto in the same manner as such determination is made in the case of a taxpayer on the per-country foreign tax credit limitation for the taxable year (see subdivision (i) of this subparagraph).

(vi) *Examples.* The principles of this subparagraph may be illustrated by the following examples in each of which the taxpayer is an individual and a citizen of the United States:

Example 1. The taxpayer's only items of income and deduction relating to excess investment interest are as follows:

	United States	France	Germany	Total
Investment income from sources within	$150,000	$120,000	$180,000	$450,000
Investment expenses relating to income from sources within	(100,000)	(90,000)	(120,000)	(310,000)
Net investment income	50,000	30,000	60,000	140,000
Investment interest expense relating to income from sources within	(110,000)	(70,000)	(50,000)	(230,000)
(Excess) of investment interest expense over net investment income	(60,000)	(40,000)	*10,000	(90,000)

*Excess of net investment income over investment interest expense.

(a) If the taxpayer has elected the overall foreign tax credit limitation, his excess investment interest from sources within any foreign countries or possessions of the United States determined under subdivision (ii) of this subparagraph is computed as follows:

Investment interest:			
French	($70,000)		
German	(50,000)		($120,000)
Net investment income:			
Investment income:			
French	120,000		
German	180,000	$300,000	
Less:			
Investment expenses:			
French	(90,000)		
German	(120,000)	(210,000)	90,000
Excess of U.S. net income over investment interest expenses:			
Total foreign excess investment interest			(30,000)

(b) If the taxpayer is on the per-country foreign tax credit limitation, his excess investment interest from France and Germany determined under subdivision (i)(*a*) of this subparagraph is $40,000 and zero, respectively. Since the taxpayer's worldwide excess investment interest ($90,000) is less than his total separately determined excess investment interest ($60,000 (United States) plus $40,000 (French) plus zero (German), or $100,000), the limitation in subdivision (i) (*b*) of this subparagraph applies and the excess investment interest attributable to France is limited as follows:

Total worldwide excess ($90,000) / Total separately determined excess ($100,000) × French excess ($40,000) = $36,000

The taxpayer's total excess investment interest attributable to sources within any foreign country or possession of the United States is, thus, $36,000 ($36,000 (French) plus zero (German)). The taxpayer's excess investment interest attributable to sources within the United States is $54,000

($90,000 / $100,000 × $60,000).

Since, in making the latter determination, $6,000 of the $60,000 of U.S. investment interest expense in excess of U.S. net investment income is, in effect, offset by German net investment income, for purposes of §1.58–7(c), $6,000 of interest deductions attributable to income from sources within the United States are, pursuant to subdivision (iv) of this subparagraph, treated as deductions attributable to income from sources within Germany.

Example 2. Assume the same facts as in example (1) except that the items of income and deduction in Germany and the United States are reversed. The worldwide excess investment interest, thus, remains $90,000 and the items of income and deduction relating to excess investment interest are as follows:

	United States	France	Germany	Total
Investment income from sources within	$180,000	$120,000	$150,000	$450,000
Investment expenses relating to income from sources within	(120,000)	(90,000)	(100,000)	(310,000)
Net investment income	60,000	30,000	50,000	140,000
Investment interest expense relating to income from sources within	(50,000)	(70,000)	(110,000)	(230,000)
(Excess) of investment interest expense over net investment income	10,000	(40,000)	(60,000)	(90,000)

(a) If the taxpayer has elected the overall limitation, his excess investment interest from sources within any foreign countries or possessions of the United States determined under subdivision (ii) of this subparagraph is determined as follows:

Foreign investment interest:			
French	($70,000)		
German	(110,000)		($180,000)
Foreign net investment income:			
French	120,000		
German	150,000	$270,000	
Less:			
Investment expenses:			
French	(90,000)		
German	(100,000)	(190,000)	80,000
Excess of U.S. net investment income over U.S. investment interest expense			10,000
Excess investment interest attributable to foreign sources			(90,000)

(b) If the taxpayer has not elected the overall foreign tax credit limitation, his excess investment interest from France and Germany determined under subdivision (i) of this subparagraph (without regard to the limitation to worldwide excess investment interest) is $40,000 and $60,000 respectively, and his total separately determined excess investment interest is, thus, $10,000. Since the total separately determined excess would exceed the worldwide excess, the limitation to the worldwide excess in subdivision (i) applies and the excess investment interest is determined as follows:

France:

$90,000 / $100,000 × $40,000 = $36,000

Germany:

$90,000 / $100,000 × $60,000 = $54,000

Total excess investment interest attributable to sources within any foreign countries and possessions—$90,000.

Example 3. Assume the same facts as in example (1) except that the taxpayer, in addition has investment income, investment expenses, and investment interest subject to the separate limitation under section 904(f).

(a) If the taxpayer has elected the overall foreign tax credit limitation, his excess investment interest from sources within any foreign countries or possessions of the United States determined under subdivision (ii) of this subparagraph is the same as in (a) of example (1) of this subdivision (vi). He then treats such amount as separately determined excess investment interest attributable to a single foreign country as determined under subdivision (i) of this subparagraph and proceeds as in (b) of example (1) of this subdivision (vi) treating items of income and deduction subject to section 904(f) and from each separate foreign country or possession separately in making the additional determinations under subdivisions (i) and (iv) of this subparagraph.

(b) If the taxpayer has not elected the overall foreign tax credit limitation, his excess investment interest from sources within any foreign country or possession of the United States would be determined in the same manner as in (b) of example (1) treating items of income and deduction which are subject to section 904(f) and from each separate foreign country or possession separately in making the determinations under subdivisions (i) and (iv) of this subparagraph.

(c) *Reduction in taxes on United States source income*—(1) *Overall limitation*—(i) *In general.* If a taxpayer is on the overall foreign tax credit limitation under section 904(a)(2), the items of tax preference determined to be attributable to foreign sources under paragraph (b) of this section reduce the tax imposed by chapter 1 (other than the minimum tax imposed under section 56) on income from sources within the United States for the taxable year to the extent of the smallest of the following three amounts:

(*a*) Items of tax preference (other than stock options and capital gains) attributable to sources within a foreign country or possession of the United States,

(*b*) The excess (if any) of the total deductions properly allocable or apportionable to items or classes of gross income from sources within foreign countries and possessions of the United States over the gross income from such sources, or

(*c*) Taxable income from sources within the United States.

See § 1.58–7(b)(2)(iv) with respect to the attribution of certain interest deductions to foreign sources in cases involving the excess investment interest item of tax preference.

(ii) *Net operating loss.* Where there is an overall net operating loss for the taxable year, to the extent that the lesser of the amounts determined under (*a*) or (*b*) of subdivision (i) of this subparagraph exceeds the taxpayer's taxable income from sources within the United States (and, therefore do not offset taxable income from sources within the United States for the taxable year) the amount of such excess is treated as ''suspense preferences.'' Suspense preferences are converted to actual items of tax preference, arising in the loss year and subject to the provisions of section 56, as the net operating loss is used in other taxable years, in the form of a net operating loss deduction under section 172, to offset taxable income from sources within the United States. Suspense preferences which, in other taxable years, reduce taxable income from sources within any foreign country or possession of the United States lose their character as suspense preferences and, thus, are never converted into actual items of tax preference. The amount of the suspense preferences which are converted into actual items of tax preference is equal to that portion of the net operating loss attributable to the suspense preferences which offset taxable income from sources within the United States in taxable years other than the loss year. The determination of the component parts of the net operating loss and the determination of the amount by which the portion of the net operating loss attributable to suspense preferences offsets taxable income from sources within the United States is made on a year-by-year basis in the same order as the net operating loss is used in accordance with section 172(b). Such determination is made by applying deductions attributable to U.S. source income first against such income and deductions attributable to foreign source income first against such foreign source income and in accordance with the following principles:

(*a*) Deductions attributable to items or classes of gross income from sources within the United States offset taxable income from sources within the United States before any remaining portion of the net operating loss;

(*b*) Deductions attributable to items or classes of gross income from sources within foreign countries or possessions of the United States offset taxable income from such sources before any remaining portion of the net operating loss;

(*c*) Deductions described in (*b*) of the subdivision (ii) which are not suspense preferences (referred to in this subparagraph as "other foreign deductions") offset taxable income from sources within foreign countries and possessions of the United States before suspense preferences; and

(*d*) Suspense preferences offset taxable income from sources within the United States before other foreign deductions.

For purposes of the above computations, taxable income is computed with the modifications specified in section 172(b)(2) or section 172(c), whichever is applicable. However, the amount of suspense preferences which are converted into actual items of tax preference in accordance with the above principles is reduced to the extent suspense preferences offset increases in taxable income from sources within the United States due to the modifications specified in section 172(b)(2) or section 172(c). For this purpose, suspense preferences are considered to offset an increase in taxable income due to the section 172(b)(2) modifications only after reducing taxable income computed before the section 172(b)(2) or section 172(c) modifications.

(iii) *Examples.* The principles of this subparagraph may be illustrated by the following examples. In each example the taxpayer is an individual citizen of the United States and has elected the overall foreign tax credit limitation. Personal deductions and exemptions are disregarded for purposes of these examples.

Example 1. In 1974, the taxpayer has the following items of income and deduction:

United States taxable income:			
Gross income		$750,000	
Deductions		(250,000)	$500,000
Foreign source loss:			
Gross income		200,000	
Deductions:			
Preference items (excess of percentage depletion over basis)	$550,000		
Other	50,000	(600,000)	(400,000)
Overall taxable income			100,000

Pursuant to subdivision (i) of this subparagraph the smallest of (a) the items of tax preference attributable to the foreign sources ($550,000), (b) the foreign source loss ($400,000), or (c) the taxable income from sources within the United States ($500,000) reduces the tax imposed by chapter 1 (other than the minimum tax) on income from sources within the United States. Thus, $400,000 of the $550,000 of excess depletion is treated as an item of tax preference in 1974 subject to the minimum tax.

Example 2. Assume the same facts as in example (1) except that the gross income from sources within the United States is $350,000 resulting in U.S. taxable income of $100,000 and an overall net operating loss of $300,000. Pursuant to subdivision (i) of this subparagraph, $100,000 of the $550,000 excess depletion would be treated as an item of tax preference in 1974 subject to the minimum tax. In addition, pursuant to subdivision (ii) of this subparagraph, the excess of the items of tax preference from foreign sources ($550,000) or the foreign source loss ($400,000), whichever is less, over the U.S. taxable income ($100,000), or, in this example, $300,000, is treated as suspense preferences.

(a) If, in 1971, the taxpayer's total items of income and deduction result in $350,000 of taxable income all of which is from sources within the United States, the entire $300,000 net operating loss, all of which is attributable to suspense preferences, is used to offset U.S. taxable income. Accordingly, the full $300,000 of suspense preferences are converted into actual items of tax preference arising in 1974 and are subject to tax under section 56.

(b) If the $350,000 in 1971 is modified taxable income resulting from the denial of a section 1202 capital gains deduction of $175,000 by reason of section 172(b)(2), the $300,000, otherwise treated as actual items of tax preference, is reduced by $125,000, *i.e.*, the extent to which the suspense preferences offset U.S.

taxable income attributable to the increase in taxable income resulting from the denial of the section 1202 deduction.

Example 3. In 1974, the taxpayer has the following items of income and deduction:

United States loss:			
Gross income		$75,000	
Deductions		(225,000)	
			($150,000)
Foreign loss:			
Gross income		400,000	
Deductions:			
Preference items (excess of accelerated depreciation on sec. 1250 property over straight-line amount)	$200,000		
Other	550,000	(750,000)	(350,000)
Overall net operating loss			(500,000)

Since the nonpreference deductions reduce the foreign source income before the preference portion, the $350,000 foreign source loss consists of $200,000 of suspense preferences and $150,000 of other deductions. In 1971, 1972, and 1973 the taxpayer had taxable income from sources within the United States of $100,000, $200,000, and $300,000, respectively and taxable income from sources within foreign countries of $80,000 each year. Of the $200,000 of suspense preferences, $150,000 are converted into actual items of tax preference, subject to the minimum tax in 1974, determined as follows:

[In thousands of dollars]

Year—Explanation	Taxable income		U.S. deductions	Foreign deductions	
	U.S. source	Foreign source		Suspense preferences	Other
1971 End of year balance before section 58(g) computations	100	80	150	200	150
1. U.S. deductions against U.S. income	(100)		(100)		
2. Other foreign deductions against foreign income		(80)			(80)
1972 End of year balance before section 58(g) computations	200	80	50	200	70
1. U.S. deductions against U.S. income	(50)		(50)		
2. Other foreign deductions against foreign income		(70)			(70)
3. Suspense preferences against foreign income		(10)		(10)	
4. Suspense preferences against U.S. income	*(150)			*(150)	
1973 End of year balance before section 58(g) computations	300	80		40	
1. U.S. deductions against U.S. income			Not applicable		
2. Other foreign deductions against foreign income			Not applicable		
3. Suspense preference against foreign income		(40)		(40)	
4. Suspense preferences against U.S. income			Not applicable		
Balances	300	40			

*Suspense preferences converted to actual items of tax preference.

Example 4. In 1970, the taxpayer's total items of income and deduction, all of which are attributable to foreign sources, are as follows:

Foreign loss:		
Gross income	$400,000	
Deductions:		
Preferences (excess of accelerated depreciation on section 1250 property over straight-line)	$200,000	
Net operating loss		350,000

Pursuant to subdivision (i) of this subparagraph, none of the preferences attributable to foreign sources reduce the tax imposed by chapter 1 (other than the minimum tax) on taxable income from sources within the United States. Pursuant to subdivision (ii) of this subparagraph, the $200,000 portion of the net operating loss resulting from the excess accelerated depreciation constitutes suspense preferences. No part of the net operating loss that is carried back to previous years is reduced in such previous years. In 1971 and 1972, the taxpayer's income (before the net operating loss deduction) consists of the following:

1971 taxable income:	
United States	$160,000
Foreign	70,000
Total	230,000
1972 taxable income:	
United States	25,000
Foreign	105,000
Total	130,000

(a) In 1971, the conversion of suspense preferences into actual items of tax preference under section 58(g) (and this paragraph) and the imposition of the minimum tax on 1970 items of tax preference under section 56(b) and (§ 1.56A–2) are determined as follows:

Conversion of suspense preferences:

1970 NET OPERATING LOSS

[In thousands of dollars]

	U.S. taxable income	Foreign taxable income	U.S. deductions	Suspense preferences	Other foreign deductions
	$160	$70	....	$200	$150
1. U.S. deductions against U.S. income			Not applicable.		
2. Other foreign deductions against foreign income.	....	70	....	....	(70)
3. Suspense preference against foreign income.			Not applicable.		
4. Suspense preference against U.S. income	*(160)	....	....	(160)	
Balance to 1972				40	80

*Suspense preferences converted into actual items of tax preference.

Imposition of minimum tax on 1970 items of tax preference:

1970 NET OPERATING LOSS

[In thousands of dollars]

	1971 taxable income	Nonpreference portion	Preference portion	Suspense portion
	$230	$150	....	$200
1. 1971 conversion of suspense preferences pursuant to sec. 58(g)	....	[1] 30	$130	(160)
Adjusted NOL	....	180	130	40
2. Nonpreference portion against taxable income	(180)	(180)		
3. Preference portion against taxable income	[2] (50)	....	(50)	
Balance to 1972			80	40

[1] Represents the 1970 minimum tax exemption.
[2] Imposition of 1970 minimum tax (10 pct × $50,000 = $5,000).

(b) In 1972, the conversion of suspense preferences into actual items of tax preferences under section 58(g) (and this paragraph) and the imposition of the minimum tax on 1970 items of tax preference under section 56(b) (and § 1.56A–2) are determined as follows:

Conversion of suspense preferences:

1970 NET OPERATING LOSS

[In thousands of dollars]

	U.S. taxable income	Foreign taxable income	U.S. deductions	Suspense preferences	Other foreign deductions
	$25	$105	....	$40	$80
1. U.S. deduction against U.S. income			Not applicable		
2. Other foreign deductions against foreign income	....	(80)	....	....	(80)
3. Suspense preferences against foreign income	....	(25)	....	(25)	
4. Suspense preference against U.S. income	[1] (15)	....	....	(15)	
Balance	10				

[1] Suspense preferences converted into actual items of tax preference.

Imposition of minimum tax on 1970 items of tax preference:

1970 NET OPERATING LOSS

[In thousands of dollars]

	1972 taxable income	Nonpreference portion	Preference portion	Suspense portion
	$130	....	$80	$40
1. 1972 conversion of suspense preferences pursuant to sec. 58(g)	....	$25	15	(40)
Adjusted NOL	....	25	95	
2. Nonpreference portion against taxable income	(25)	(25)		
3. Preference portion against taxable income	[1] (95)	....	(95)	
Balance	10			

[1] Imposition of 1970 minimum tax (10 pct × $95,000 = $9,500).

(2) *Per-country limitation*—(i) *In general*. If a taxpayer is on the per-country foreign tax credit limitation for the taxable year, the amount by which the items of tax preference to which this section applies reduce the tax imposed by chapter 1 (other than the minimum tax under section 56) on income from sources within the United States is determined separately with respect to each foreign country or possession of the United States. Such determination is made in a manner consistent with subparagraph (1) of this paragraph as modified in subdivision (ii) of this subparagraph. In applying subparagraph (1)(i) of this paragraph to a taxpayer on the per-country limitation, if the total potential preference amounts (as defined in this subdivision (i)) exceed the taxpayer's taxable income from sources within the United States, then, for purposes of subparagraph (1)(i)(*c*) of this paragraph (relating to the U.S. taxable income limitation on the amount treated as a reduction of U.S. taxable income), the taxable income from sources within the United States which is reduced by potential preference amounts with respect to each foreign country or possession is an amount which bears the same relationship to such income as the potential preference amount with respect to such foreign country or possession bears to the total of the potential preference amounts with respect to all foreign countries and possessions. For purposes of this subparagraph, the potential preference amount with respect to a foreign country or possession is the lesser of the amount of foreign source preference (described in subparagraph (1)(i)(*a*) of this paragraph) attributable to such country or possession or the amount of foreign source loss (described in subparagraph (1)(i)(*b*) of this paragraph) attributable to such country or possession.

(ii) *Net operating loss.* Where there is an overall net operating loss for the taxable year and the total of the potential preference amounts with respect to all foreign countries and possessions exceeds the taxpayer's taxable income from sources within the United States, the amount of such excess is treated as ''suspense preferences''. The suspense preferences are converted into actual items of tax preference, arising in the loss year and subject to the provisions of section 56, as the net operating loss is used in other taxable years, in the form of a net operating loss deduction under section 172, to offset taxable income from sources within the United States. Suspense preferences attributable to a foreign country or possession which, in other taxable years, reduce taxable income from sources within such country or possession or offset taxable income from sources within any other foreign country or possession lose their character as suspense preferences and, thus, are never converted into actual items of tax preference. The amount of the suspense preferences which are converted into actual items of tax preference is equal to that portion of the net operating loss attributable to the suspense preferences which offsets taxable income from sources within the United States in taxable years other than the loss year. The determination of the component parts of the net operating loss and the determination of the amount by which the portion of the net operating loss attributable to the suspense preferences offsets taxable income from sources within the United States is made on a year-by-year basis in the same order as the net operating loss is used in accordance with section 172(b). Such determination is made by applying deductions attributable to United States source income first against such income and applying deductions attributable to income from sources within a foreign country or possession of the United States first against income from sources within such country or possession and in accordance with the following principles:

(*a*) Deductions attributable to items or classes of gross income from sources within the United States offset taxable income from sources within the United States before any remaining deductions;

(*b*) Deductions attributable to items or classes of gross income from sources within any foreign country or possession of the United States which are not suspense preferences (referred to in this paragraph as ''other foreign deductions'') offset taxable income from sources within such country or possession before any remaining deductions;

(*c*) Suspense preferences attributable to items or classes of gross income from sources within a foreign country or possession offset any remaining taxable income from sources within such foreign country or possession after application of (*b*) of this subdivision (ii) before any remaining deductions;

(*d*) Suspense preferences from each foreign country and possession (remaining after application of (*c*) of this subdivision (ii)) offset taxable income from sources within the United States (remaining after application of (*a*) of this subdivision (ii)) before other foreign deductions pro rata on the basis of the total of such suspense preferences;

(*e*) Other foreign deductions from each foreign country and possession (remaining after application of (*b*) of this subdivision (ii)) offset taxable income from sources within the United States (remaining after application (*a*) and (*b*) of this subdivision (ii)) pro rata on the basis of the total of such other foreign deductions;

(*f*) Deductions attributable to income from sources within the United States (remaining after application of (*a*) of this subdivision (ii)) offset taxable income from sources within any foreign country or possession before any foreign deductions;

(*g*) Other foreign deductions from each foreign country and possession (remaining after application of (*b*) and (*e*) of this subdivision (ii)) offset taxable income from sources within any other foreign countries or possessions (remaining after application of (*f*) of this subdivision (ii)) pro rata on the basis of the total of such other foreign deductions; and

(*h*) Suspense preferences (remaining after the application of (*c*) and (*d*) of this subdivision (ii)) offset taxable income from sources within any foreign country or possession (remaining after the application of paragraphs (*f*) and (*g*) of this subdivision (ii)) pro rata on the basis of the total of such suspense preferences.

For purposes of the above computations, taxable income is computed with the modifications specifed in section 172(b)(2) or section 172(c), whichever is applicable. However, the amount of suspense preferences which are converted into actual items of tax preference in accordance with the above principles is reduced to the extent the suspense preferences offset increases in taxable income from sources within the United States due to the modifications specified in section 172(b)(2) or section 172(c). For this purpose, suspense preferences are considered to offset an increase in taxable income due to section 172(b)(2) or section 172(c) modifications only after reducing taxable income computed before such modifications.

(iii) *Examples.* The principles of this subparagraph may be illustrated by the following examples in each of which the per-country foreign tax credit limitation is applicable. For purposes of these examples, personal deductions and exemptions are disregarded.

Example (1). The taxpayer has the following items of income and deduction for the taxable year 1971:

	United States	France	Germany	United Kingdom
Gross income	$180,000	$165,000	$50,000	$75,000
Deductions:				
Preference	....	....	....	(45,000)
Other	(120,000)	(125,000)	(80,000)	(100,000)
Taxable income (or loss)	60,000	40,000	(30,000)	(70,000)

(a) Pursuant to subdivision (i) of this subparagraph, the potential preference amount in the case of the United Kingdom is the lesser of the preferences attributable to the United Kingdom ($45,000) or the excess of deductions over gross income from sources within the United Kingdom ($70,000) and the potential preference amounts in the case of France and Germany are zero in both cases since the preferences attributable to both countries are zero. Since the total potential preference amounts ($45,000) is less than the taxable income from sources within the United States ($60,000), no modification of U.S. taxable income is required. Thus, the amount by which the U.K. preferences reduce the tax on taxable income from sources within the United States, determined in a manner consistent with subparagraph (1)(i) of this paragraph, is the smallest of (1) the items of tax preference attributable to the United Kingdom ($45,000), (2) the excess of deductions over gross income attributable to the United Kingdom ($70,000), or (3) taxable income from sources within the United States ($60,000). The full $45,000 of U.K. preference items are, therefore, taken into account as items of tax preference in 1971 and subject to the minimum tax. Since there is no net operating loss, subdivision (ii) of this subparagraph does not apply.

(b) If the French taxable income is $15,000 instead of $40,000, a $25,000 net operating loss (on a worldwide basis) results. The determination of the foreign preference items taken into account pursuant to subdivision (i) of this subparagraph is the same as in (a) of this example. Subdivision (ii) of this subparagraph again does not apply since the total potential preference amounts ($45,000) is less than the U.S. taxable income ($60,000).

Example 2. For the taxable year 1972, the taxpayer has a net operating loss of $35,000 consisting of the following items of income and deduction:

	United States	France	Germany	United Kingdom	Belgium
Gross income	$250,000	$50,000	$60,000	$5,000	$45,000
Deductions:					
Preferences	....	(35,000)	(70,000)	(95,000)	
Other	(100,000)	(75,000)	(30,000)	....	(40,000)
Taxable income (or loss)	150,000	(60,000)	(40,000)	(90,000)	5,000

(a) Pursuant to subdivision (i) of this subparagraph the potential preference amount with respect to each country is the lesser of the amount shown as preferences with respect to such country or the amount of the loss from such country. Thus, the potential preference amounts in this case are:

France	$35,000
Germany	40,000
United Kingdom	90,000
Belgium	0
Total	165,000

Since the total of the potential preference amounts exceeds the U.S. taxable income, in applying the principles of subparagraph (1)(i) of this paragraph, U.S. taxable income which is reduced by potential preference amounts with respect to each country is a pro-rata amount based on the total potential preference amounts as follows:

France	(35,000 / 165,000 × $150,000)—$31,818
Germany	(40,000 / 165,000 × $150,000)—$36,364
United Kingdom	(90,000 / 165,000 × $150,000)—$81,818
Belgium	(0 / 165,000 × $150,000)—$0
Total	$150,000

The amount by which the foreign preference items offset U.S. taxable income pursuant to subdivision (i) of this subparagraph is then determined as follows:

	(a)	(b)	(c)	(d)
	Preferences	Loss	U.S. taxable income	Smallest of (a), (b), or (c)
France	$35,000	$60,000	$81,818	$31,818
Germany	70,000	40,000	36,364	36,364
United Kingdom	95,000	90,000	81,818	81,818
Belgium.				
Total	....	....	....	150,000

Thus, $150,000 of the total foreign preference items will be taken into account pursuant to subdivision (i) of this subparagraph as items of tax preference in 1972 and subject to the provisions of section 56.

(b) Pursuant to subdivision (ii) of this subparagraph, the 1972 net operating loss of $35,000 will consist of suspense preferences of $15,000 and other foreign deductions of $20,000 attributable to each foreign country as shown below and determined as follows:

Explanation	Deductions						
	United States	France		Germany		United Kingdom preferences	Belgium other
		Preferences	Other	Preferences	Other		
	$100,000	$35,000	$75,000	$70,000	$30,000	$95,000	$40,000
1. U.S. deductions against U.S. income ($250,000)	(100,000)						
2. Other foreign deductions against foreign income (per-country) [1]	....	....	(50,000)	....	(30,000)	....	(40,000)
3. Suspense preferences against remaining foreign income (per-country)	....	....	....	(30,000)	....	(5,000)	
4. Suspense preferences against remaining U.S. income:							
France (35,000 / 165,000 × $150,000)	....	(31,818)					
Germany (40,000 / 165,000 × $150,000)	....	....	....	(36,364)			
U.K. (90,000 / 165,000 × $150,000)	....	....	....	....	....	(81,818)	
5. Other foreign deductions against remaining U.S. income (0)	(2)	(2)	(2)	(2)	(2)	(2)	(2)
6. U.S. deductions against other foreign income	(2)	(2)	(2)	(2)	(2)	(2)	(2)
7. Other foreign deductions against remaining foreign income ($5,000)	....	....	(5,000)				
8. Suspense preferences against remaining foreign income (0):	(2)	(2)	(2)	(2)	(2)	(2)	(2)
Balance (components of NOL)	....	3,182	20,000	3,636	....	8,182	

[1] Foreign income amounts before step 2 are: France—$50,000; Germany—$60,000; United Kingdom—$5,000; Belgium—$45,000.
[2] Not applicable.

Example 3. In 1973, the taxpayer has taxable income (computed without regard to the net operating loss deduction) from the following sources and in the following amounts:

United States	France	Germany	United Kingdom
$100,000	$60,000	$20,000	$30,000

In addition, the taxpayer has a net operating loss deduction of $235,000 resulting from a 1972 net operating loss consisting of the following amounts:

Deductions attributable to income from sources within the United States	$25,000
Suspense preferences attributable to income from sources within France	$75,000
Deductions other than suspense preferences attributable to income from sources within France	$85,000
Deductions other than suspense preferences attributable to sources within the Netherlands	$50,000

(*a*) Pursuant to subdivision (ii) of this subparagraph, the converted suspense preferences and the remaining portions of the 1972 net operating loss carried over to 1974 are computed as follows:

[In thousands of dollars]

	1973 income				1972 net operating loss			
	United States	France	Germany	United Kingdom	United States	French suspense preferences	French other deductions	Dutch other deductions
	100	60	20	30	25	75	85	50
U.S. deductions against U.S. income	(25)	....	....	....	(25)			
Other foreign deductions against foreign income (per-country)	....	(60)	....	....	....	....	(60)	
Suspense preferences against remaining foreign income (per-country)	([2])	([2])	([2])	([2])	([2])	([2])	([2])	([2])
Suspense preferences against remaining U.S. income	([1] 75)	....	....	....	....	(75)		
Other foreign deductions against remaining U.S. income	([2])	([2])	([2])	([2])	([2])	([2])	([2])	([2])
U.S. deductions against remaining foreign income	([2])	([2])	([2])	([2])	([2])	([2])	([2])	([2])
Other foreign deductions against remaining foreign income:								
French (25,000/75,000 × $50,000)	....	....	(16.7)	....	....	....	(16.7)	
Dutch (50,000/75,000 × $50,000)	....	....	(33.3)	....	....	....	....	(33.3)
Suspense preferences against remaining foreign income	([2])	([2])	([2])	([2])	([2])	([2])	([2])	([2])
Balance (1972 carryover to 1974)	....	....	....	....	....	....	8.3	16.7

[1] Suspense preferences converted to actual items of tax preference.
[2] Not applicable.

(*b*) If, in 1972, there had been no items of tax preference without regard to the suspense preferences, the conversion of the suspense preferences in 1973 would result in a 1972 minimum tax liability under section 56(a) of $4,500 (10 percent × ($75,000 − $30,000)), all of which would have been deferred by reason of section 56(b). Further, by application of section 56(b) and § 1.56A–2, $20,000 of the $45,000 preference portion of the 1972 net operating loss would be treated as having reduced taxable income in 1973 resulting in the imposition in 1973 of $2,000 of the deferred 1972 minimum tax liability.

(3) *Separate limitation under section 904(f).* In the case of a taxpayer subject to the separate limitation on interest income under section 904(f), the provisions of this paragraph shall be applied in the same manner as in subparagraph (2) of this paragraph. If the taxpayer has elected the overall foreign tax credit limitation, subparagraph (2) of this paragraph shall be applied as if all income from sources within any foreign countries or possessions of the United States and deductions relating to income from such sources other than income or deductions subject to the separate limitation under section 904(f) were from a single foreign country.

(4) *Carryover of excess taxes.* For rules relating to carryover of excess taxes described in paragraph (1) of section 56(c) when suspense preferences are converted to actual items of tax preference, see § 1.56A–5(f).

(5) *Character of amounts.* Where the amounts from sources within a foreign country or possession of the United States (or all such countries or possessions in the case of a taxpayer who has elected the overall foreign tax credit limitation) which are treated as reducing chapter 1 tax on income from sources within the United States or as suspense preferences are less than the total items of tax preference described in subparagraph (1)(i)(*a*) of this paragraph attributable to such sources, the amounts so treated are considered derived proportionately from each such item of tax preference.

[T.D. 7564, 43 FR 40484, Sept. 12, 1978, as amended by T.D. 8138, 52 FR 15309, Apr. 28, 1987]

§ 1.58–8 Capital gains and stock options.

(a) *In general.* Section 58(g)(2) provides that the items of tax preference specified in section 57(a)(6), and § 1.57–1(b) (stock options), and section 57(a)(9), and § 1.57–1(i) (capital gains), which are attributable to sources within any foreign country or possession of the United States shall not be taken into account as items of tax preference if, under the tax laws of such country or possession, preferential treatment is not accorded:

(1) In the case of stock options, to the gain, profit, or other income realized from the transfer of shares of stock pursuant to the exercise of an option which is under United States tax law a qualified or restricted stock option (under section 422 or section 424); and

(2) In the case of capital gains, to gain from the sale or exchange of capital assets (or property treated as capital assets under United States tax law).

Where capital gains are not accorded preferential treatment within a foreign country, capital losses as well as capital gains from such country are not taken into account for purposes of the minimum tax.

(b) *Source of capital gains and stock options.* Generally, in determining whether the capital gain or stock option item of tax preference is attributable to sources within any foreign country or possession of the United States, the principles of sections 861–863 and the regulations thereunder are applied. Thus, the stock option item of tax preference, representing compensation for personal services, is attributable, in accordance with § 1.861–4, to sources within the country in which the personal services were performed. Where the capital gain item of tax preference represents gain from the purchase and sale of personal property, such gain is attributable, in accordance with § 1.861–7, entirely to sources within the country in which the property is sold. In accordance with paragraph (c) of § 1.861–7, in any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, all factors of the transaction, such as negotiations, the execution of the agreement, the location of the property, and the place of payment, will be considered, and the sale will be treated as having been consummated at the place where the substance of the sale occurred.

(c) *Preferential treatment.* For purposes of this section, gain, profit, or other income is accorded preferential treatment by a foreign country or possession of the United States if (1) recognition of the income, for foreign tax purposes, is deferred beyond the taxpayer's taxable year or comparable period for foreign tax purposes which coincides with the taxpayer's U.S. taxable year in cases where other items of profit, gain, or other income may not be deferred; (2) it is subject to tax at a lower effective rate (including no rate of tax) than other items of profit, gain, or other income, by means of a special rate of tax, artifical deductions, exemptions, exclusions, or similar reductions in the amount subject to tax; (3) it is subject to no significant amount of tax; or (4) the laws of the foreign country or possession by any other method provide tax treatment for such profit, gain, or other income more beneficial than the tax treatment otherwise accorded income by such country or possession. For the purpose of the preceding sentence, gain, profit, or other income is subject to no significant amount of tax if the amount of taxes imposed by the foreign country or possession of the United States is equal to less than 2.5 percent of the gross amount of such income.

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

Example 1. The Bahamas imposes no income tax on individuals or corporations, whether resident or nonresident. Since capital gains are subject to no tax in the Bahamas, capital gains are considered to be accorded preferential treatment and will be taken into account for purposes of the minimum tax.

Example 2. In France, except in certain cases involving the sale of large blocks of stock, a nonresident individual is not subject to tax on isolated capital gains transactions. Since such capital gains are not subject to tax in France, they are considered to be accorded preferential treatment irrespective of the treatment accorded other capital gains in France and such gains will be taken into account for purposes of the minimum tax.

Example 3. In Germany, in the case of the sale within 1 taxable year of 1 percent or more of the shares of a corporation in which an individual taxpayer is regarded as holding a substantial interest, the gains on the sale of the large block of stock will be taxed as extraordinary income at one-half the ordinary income tax rate. Since these gains are taxed as a reduced rate of tax in comparison to other income, they are considered to be accorded preferential treatment and will be taken into account for purposes of the minimum tax.

Example 4. In Belgium, gains derived by an individual in the course of regular speculative transactions are taxed as ordinary income, but with an upper limit of 30 percent. Rates of tax on individuals in Belgium range from approximately 30 percent to approximately 60 percent. Since the gains on speculative transactions are taxed at a maximum rate which is more beneficial then the rates accorded to other income, such gains are considered to be accorded preferential treatment and will be taken into account for purposes of the minimum tax.

Example 5. In France, gains derived by a company on the sale of fixed assets held for less than 2 years are treated as short-term gains. The excess of short-term gains in any fiscal year is taxed at the full company tax rate of 50 percent. However, this tax may be paid in equal portions over the 5 years immediately following the realization of such short-term gains. Since recognition of the short-term gains for tax purposes is subject to deferral over a 5-year period, such gains are considered to be accorded preferential treatment and will be taken into account for purposes of the minimum tax.

Example 6. Also in France, in the case of the sale or exchange by a company of depreciable assets and nondepreciable asset owned for at least 2 years, the excess of long-term capital gains over long-term capital losses in a fiscal year is subject to an immediate tax at the reduced rate of 10 percent. Such excess, reduced by the 10-percent tax, is carried in a special reserve account on the taxpayer's books. If the excess is reinvested in other fixed asset within a stated period, no further tax is due. If the amounts in the special reserve are distributed, they will be treated as ordinary income for the fiscal year in which the distribution is made. Since such gains (other than those distributed in the same fiscal year they are realized) are subject to deferral or a reduced rate of tax, they are (except to the extent distributed in the year of realization) considered to be accorded preferential treatment and are taken into account for purposes of the minimum tax.

Example 7. In Sweden, in the case of gains derived by an individual on the sale of shares or bonds held for 5 years or less, 25 percent of the gains are taxed if the holding period is 4 to 5 years, 50 percent of the gain is taxed if the holding period is 3 to 4 years, and 75 percent of the gain is taxed if the holding period is 2 to 3 years. The gain is fully taxable at ordinary income rates if held for less than 2 years. Thus, gains on shares or bonds held for 2 years or more are considered accorded preferential treatment in Sweden since they are either subject to exemption or treatment comparable to the U.S. capital gains deduction and are taxed at a reduced rate. Thus, such gains are taken into account for purposes of the minimum tax.

Example 8. Pursuant to Article XIV of the United States-United Kingdom Income Tax Convention, a resident of the United States is exempt from United Kingdom tax on most capital gains. Since such capital gains are exempt from United Kingdom taxation, they are considered to be accorded preferential treatment and are taken into account for purposes of the minimum tax.

Example 9. An individual resident of the United States, is desirous of selling his stock in a corporation listed on the New York Stock Exchange. He requests the stock certificates from his broker in the United States, travels to a foreign country, delivers the certificates to a broker in that country, and has the foreign broker execute the sale which takes place on the New York Stock Exchange. Since the sale was consummated in the United States, pursuant to paragraph (b) of this section and §1.861–7, the resulting capital gain item of tax preference is attributable to sources within the United States.

Example 10. Two individuals, both residing in the United States, negotiate and reach agreement in New York City for the sale of stock of a closed corporation. Prior to the transfer of the stock, in order to avoid imposition of the minimum tax, both individuals travel to a foreign country which does not accord preferential treatment to capital gains, but imposes a 5-percent rate of income tax which would be fully creditable against U.S. tax under sections 901 and 904 if the capital gains were sourced in that country. The stock is actually transferred and consideration paid in the foreign country. Since the primary purpose of consummating the sale in the foreign country was the avoidance of tax, pursuant to paragraph (b) of this section, and §1.861–7(c), the resulting capital gain item of tax preference will be considered attributable to sources within the country in which the substance of sale took place or, in this case, the United States.

[T.D. 7564, 43 FR 40492, Sept. 12, 1978]

§ 1.58–9 Application of the tax benefit rule to the minimum tax for taxable years beginning prior to 1987.

(a) *In general.* For purposes of computing the minimum tax liability imposed under section 56 of the Internal Revenue Code of 1954 (Code), taxpayers are not liable for minimum tax on tax preference items that do not reduce the taxpayer's tax liability under subtitle A of the Code for the taxable year. In general, tax preference items that do not reduce tax liability under subtitle A for the taxable year are those from which no current tax benefit is derived because available credits would have reduced or eliminated the taxpayer's regular tax liability if the preference items had not been allowed in computing taxable income. However, any credits that, because of such preference items, are not needed for use against regular tax (''freed-up credits''), are required to be reduced under the rules of paragraph (c) of this section. For purposes of this section, a taxpayer's regular tax is the Federal income tax liability under subchapter A of chapter 1 of the Code, not including the minimum tax imposed by section 56. Unless otherwise noted, all references to Internal Revenue Code sections refer to the Internal Revenue Code of 1954.

(b) *Effective date.* The rules of this section are effective May 5, 1992, but only as they affect tax preference items that arise in taxable years beginning after December 31, 1976, and before January 1, 1987.

(c) *Adjustment of carryover credits*—(1) *In general.* A taxpayer's freed-up credits must be reduced by the additional minimum tax that would have been imposed if a current tax benefit had been derived from preference items that did not actually produce a current tax benefit. The amount of this reduction shall be calculated in the following manner—

(i) Determine the amount of freed-up credits;

(ii) Determine the amount of tax preference items (if any) from which a current tax benefit was derived for the taxable year (''beneficial preferences''), and the amount of preferences from which no current tax benefit was derived for the taxable year (''non-beneficial preferences''); and

(iii) Determine the portion of the total minimum tax on all tax preference items for the taxable year that is attributable to the non-beneficial preferences.

The freed-up credits are then reduced by an amount equal to such portion of the minimum tax.

(2) *Determine freed-up credits.* (i) To determine the freed-up credits for the taxable year, first determine the regular tax that would have been imposed for the taxable year if preference items had not been allowed in computing taxable income (''non-preference regular tax''). In the case of a taxpayer with the capital gain preference described in section 57(a)(9)(B), non-preference regular tax is computed without regard to section 1201 and without adding the section 57(a)(9)(B) preference amount to taxable income. Second, compute the amount of credits that would have been allowed to reduce the non-preference regular tax. The credits available to reduce non-preference regular tax shall include any freed-up credits from other taxable years, as reduced under paragraph (c)(5) of this section, that are carried to the current taxable year. Third, subtract the amount of credits that were actually allowed to reduce the regular tax for such taxable year from the amount of credits that would have been allowed to reduce non-preference regular tax. The result is the amount of the freed-up credits.

(ii) The following examples illustrate the determination of freed-up credits. The first two examples assume that the foreign tax credits being used do not exceed the limitation under section 904.

Example 1. In 1982 Corporation B has $17.6 million dollars in foreign tax credits available for the taxable year. If preference items were not allowed in determining regular tax, the regular tax would have been $10.2 million and foreign tax credits used to reduce regular tax would have been $10.2 million. Because of tax preference items, however, B's regular tax is $6.3 million and the amount of foreign tax credits actually used to reduce the regular tax is $6.3 million. The amount of freed-up foreign tax credits is $3.9 million ($10.2 million minus $6.3 million).

Example 2. Assume the same facts as in *Example 1* of paragraph (c)(2)(ii) of this section except that Corporation B has $7.2 million dollars in foreign tax credits. If preference items were not allowed, the non-preference regular tax would have been $10.2 million and the foreign tax credits used to reduce the regular tax would have been $7.2 million. Because of tax preference items, however, B's regular tax is $6.3 million, and the amount of foreign tax credits actually used to reduce the regular tax is $6.3 million. The amount of freed-up foreign tax credits is $.9 million ($7.2 million minus $6.3 million).

Example 3. In 1983 Corporation C has $500,000 of investment tax credits available. If preference items were not allowed, non-preference regular tax would have been $690,000 and all $500,000 of investment tax credits would have been allowed to reduce non-preference regular tax liability. Because of tax preferences, however, C's actual regular tax is $439,750. As a result of the limitation under section 38(c), only $377,537 of the investment tax credits are allowed to reduce the actual regular tax. Freed-up credits are $122,463 ($500,000 minus $377,537).

Example 4. In 1984 Corporation B has ordinary income of $20,000 and net section 1201 gain of $300,000, none of which is attributable to foreign sources. B has no other items of tax preference in 1984. B's non-preference regular tax for 1984 is $126,950, the amount of tax that would be imposed without regard to section 1201.

(3) *Determination of beneficial and non-beneficial preferences*—(i) *In general.* The amount of tax preferences from which a current tax benefit is derived (''beneficial preferences'') and the amount from which no current tax benefit is derived (''non-beneficial preferences'') for the taxable year are determined as set forth below.

(ii) *Regular tax liability is the same regardless of preference items.* (A) If the taxpayer's tax liability (after credits) would be the same regardless of whether preference items were allowed to reduce taxable income, then all of the taxpayer's preference items are non-beneficial preference items.

(B) The following example illustrates the rule set forth in paragraph (c)(3)(ii)(A) of this section. This example assumes that foreign tax credits being used do not exceed the limitation under section 904.

Example. (i) In 1982 Corporation B has $17.6 million dollars in foreign tax credits available for the taxable year. If preference items were not allowed in determining regular tax, the regular tax would have been $10.2 million and foreign tax credits used to reduce regular tax would have been $10.2 million. Because of tax preference items, however, B's regular tax is $6.3 million and the amount of foreign tax credits actually used to reduce the regular tax is $6.3 million. The amount of freed-up foreign tax credits is $3.9 million ($10.2 million minus $6.3 million).

(ii) The total amount of B's tax preference items is $8.4 million. B's non-preference regular tax is $10.2 million and, reduced by foreign tax credits, is zero. B's actual regular tax is $6.3 million and, reduced by foreign tax credits, is zero. Since the amount of credits that would have been allowed to offset the non-preference regular tax would have reduced such tax to an amount ($0) equal to the actual regular tax liability ($0), B received a tax benefit from none of the $8.4 million of tax preferences and therefore all of these preferences are non-beneficial preferences.

(iii) *Regular tax liability differs because of preference items.* If tax liability (after credits) is less because preference items are allowed to reduce taxable income, then some of these preference items have provided a current tax benefit. In such cases, the amount of beneficial and non-beneficial preferences are determined as follows:

(A) *Non-beneficial preferences.* (*1*) The non-beneficial preferences are determined by converting the freed-up credits for such taxable year into an amount of taxable income. To make this conversion, freed-up credits are ''grossed up'' (*i.e.*, divided by the regular tax marginal rate at which such credits would have offset non-preference regular tax) to determine the amount of tax preferences that freed up such credits. For purposes of this calculation, the 5-percent addition to tax provided by section 11(b) shall be included in determining the marginal rate. The aggregate of these grossed-up amounts is the total amount of non-beneficial preferences for the taxable year.

(*2*) The freed-up credits shall be grossed up beginning at the lowest marginal tax rate that would have applied to the additional taxable income arising if tax preferences were not allowed. Thus, the marginal tax rates at which the actual regular tax was imposed shall not be taken into account in grossing up freed-up credits, even if all or a portion of such tax is not offset by credits because of limitations on the allowance of such credits (such as the section 904 limit on foreign tax credits or the section 38(c) limit on investment tax credits). For example, if the first dollar of additional non-preference taxable income would have been taxed at a rate of 46 percent, then freed-up credits shall be grossed up at 46 percent, even if regular tax imposed on taxable income at a 40-percent rate was not offset by credits because of the limitations on investment tax credits under section 38(c). *See Examples 1* and *2* in paragraph (d) of this section for illustrations of the gross up of freed-up credits in cases where limitations apply to the amount of credit allowed to offset actual regular tax.

(*3*) The following example illustrates the gross up of freed-up credits to determine non-beneficial preferences. This example assumes that foreign tax credits being used do not exceed the limitation under section 904.

Example. (i) Corporation L has the following items for the 1985 taxable year:

Actual taxable income		$90,000
Regular tax		21,750
Available credits:		
Foreign tax credits for 1985	$15,000	
Foreign tax credits carried forward from 1984	25,000	
Investment tax credits carried forward from 1984	20,000	
		60,000
Credit allowed to offset actual regular tax:		
Foreign tax credits for 1985	15,000	
Foreign tax credits carried forward from 1984	6,750	
		21,750
Actual regular tax liability		0
Preferences		110,000
Taxable income for 1985 determined as though preferences were not allowed		200,000
Non-preference regular tax		71,750
Credits allowed to offset non-preference regular tax:		
Foreign tax credits for 1985	15,000	
Foreign tax credits carried forward from 1984	25,000	
Investment tax credits carried forward from 1984	20,000	
		60,000
Non-preference regular tax liability		11,750

(ii) The freed-up credits for 1985 are $38,250 ($60,000 minus $21,750). The non-preference regular tax of $71,750 is determined by applying the regular tax rates set forth in section 11(b) to the $200,000 of taxable income as follows:

Taxable income		Rate		Tax
$25,000	X	.15	=	$3,750
25,000	X	.18	=	4,500
25,000	X	.30	=	7,500
25,000	X	.40	=	10,000
100,000	X	.46	=	46,000
$200,000				$71,750

(iii) Thus, for purposes of determining the non-beneficial preferences, freed-up credits are grossed up as follows: The credits allowed against the regular tax and the freed-up credits are treated as offsetting non-preference regular tax in the same order as such credits would have been allowed to offset such tax, beginning at the lowest marginal tax rate. The freed-up credits are grossed up beginning at the lowest marginal tax rate at which additional taxable income would have been taxed if preferences were not allowed. Thus, in this example freed-up credits are grossed up beginning at 40 percent, and the amount of L's non-beneficial preferences for the 1985 taxable year is $84,456.

Type	Credit allowed against regular tax	Freed-up credit	Divided by tax rate		Non-beneficial preferences
FTC (85)	$3,750		.15		
Do	4,500		.18		
Do	6,750		.30		
FTC (84)	750		.30		
Do	6,000		.40		
Do		$4,000	.40	=	$10,000
Do		14,250	.46	=	30,978
ITC (84)		20,000	.46	=	43,478
	$21,750	$38,250			$84,456

Foreign tax credit = FTC (year)
Investment tax credit = ITC (year)

(B) *Beneficial preferences.* The amount of beneficial preferences for the taxable year is computed by subtracting the non-beneficial preferences for the taxable year from the total amount of tax preferences for such year. This rule may be illustrated by the following example:

Example. Assume the same facts as in the *Example* in paragraph (c)(3)(iii)(A)(*3*) of this section. The amount of L's beneficial preferences for 1985 is $25,544 (total preferences of $110,000, minus non-beneficial preferences of $84,456).

(4) *Determine the minimum tax attributable to non-beneficial preferences.* (i) The portion of the minimum tax that is attributable to the non-beneficial preferences is computed as follows—

(A) Compute the minimum tax that would be imposed on all tax preference items for the taxable year if all of the preferences had produced a tax benefit.

(B) Compute the minimum tax that would be imposed on the beneficial preferences if these were the taxpayer's only preferences. (This is the amount of minimum tax actually imposed for the taxable year.)

(C) Subtract the amount computed in paragraph (c)(4)(i)(B) of this section from the amount computed in paragraph (c)(4)(i)(A) of this section. The result is the minimum tax attributable to the non-beneficial preferences for the taxable year. This amount is sometimes referred to hereinafter as the ''credit reduction amount''.

(ii) The following examples illustrate determination of the credit reduction amount. These examples assume that foreign tax credits being used do not exceed the limitation under section 904.

Example 1. (i) In 1982 Corporation B has $17.6 million dollars in foreign tax credits available for the taxable year. If preference items were not allowed in determining regular tax, the regular tax would have been $10.2 million and foreign tax credits used to reduce regular tax would have been $10.2 million. Because of tax preference items, however, B's regular tax is $6.3 million and the amount of foreign tax credits actually used to reduce the regular tax is $6.3 million. The amount of freed-up foreign tax credits is $3.9 million ($10.2 million minus $6.3 million).

(ii) The total amount of B's tax preference items is $8.4 million. B's non-preference regular tax is $10.2 million and, reduced by foreign tax credits, is zero. B's actual regular tax is $6.3 million and, reduced by foreign tax credits, is zero. Since the amount of credits that would have been allowed to offset the non-preference regular tax would have reduced such tax to an amount ($0) equal to the actual regular tax liability ($0), B received a tax benefit from none of the $8.4 million of tax preferences and therefore all of these preferences are non-beneficial preferences.

(iii) Since B has $8.4 million in total preference items and no regular tax liability, the minimum tax on that amount would be $1,258,500 (($8.4 million minus $10,000) multiplied by .15). None of the preference items is a beneficial preference. Thus, the minimum tax attributable to non-beneficial preferences (and therefore, the credit reduction amount) is $1,258,500.

Example 2. (i) Corporation L has the following items for the 1985 taxable year:

Actual taxable income		$90,000
Regular tax		21,750
Available credits:		
Foreign tax credits for 1985	$15,000	
Foreign tax credits carried forward from 1984	25,000	
Investment tax credits carried forward from 1984	20,000	
		$60,000
Credit allowed to offset actual regular tax:		
Foreign tax credits for 1985	$15,000	
Foreign tax credits carried forward from 1984	6,750	
		$21,750
Actual regular tax liability		0
Preferences		110,000
Taxable income for 1985 determined as though preferences were not allowed		200,000
Non-preference regular tax		71,750
Credits allowed to offset non-preference regular tax:		
Foreign tax credits for 1985	$15,000	
Foreign tax credits carried forward from 1984	25,000	
Investment tax credits carried forward from 1984	20,000	
		$60,000
Non-preference regular tax liability		11,750

(ii) The freed-up credits for 1985 are $38,250 ($60,000 minus $21,750). The non-preference regular tax is $71,750. The amount of L's non-beneficial preferences for the 1985 taxable year is $84,456.

(iii) The minimum tax on L's total preference items of $110,000 would be $15,000 (($110,000 minus $10,000) multiplied by .15). Since the amount of non-beneficial preferences is $84,456, the amount of L's beneficial preferences for 1985 is $25,544 ($110,000 minus $84,456). The minimum tax on L's beneficial preferences of $25,544 is $2,332 (($25,544 minus $10,000) multiplied by .15). (This is the amount of minimum tax imposed for 1985.)

The minimum tax attributable to non-beneficial preference items (and therefore, the credit reduction amount) is $12,668 ($15,000 minus $2,332).

(5) *Reduction of freed-up credits*—(i) *In general.* The freed-up credits are reduced by an amount equal to the minimum tax attributable to the non-beneficial preferences (''credit reduction amount''). If the taxpayer has only one type of freed-up credit (*i.e.*, only investment tax credit or only foreign tax credit) and that credit was earned in only one year (the current year or a carryover year), then the credit is reduced by the credit reduction amount. This rule may be illustrated by the following example. This example assumes that foreign tax credits being used do not exceed the limitation under section 904.

Example. (i) In 1982 Corporation B has $17.6 million dollars in foreign tax credits available for the taxable year. If preference items were not allowed in determining regular tax, the regular tax would have been $10.2 million and foreign tax credits used to reduce regular tax would have been $10.2 million. Because of tax preference items, however, B's regular tax is $6.3 million and the amount of foreign tax credits actually used to reduce the regular tax is $6.3 million. The amount of freed-up foreign tax credits is $3.9 million ($10.2 million minus $6.3 million).

(ii) The total amount of B's tax preference items is $8.4 million. B's non-preference regular tax is $10.2 million and, reduced by foreign tax credits, is zero. B's actual regular tax is $6.3 million and, reduced by foreign tax credits, is zero. Since the amount of credits that would have been allowed to offset the non-preference regular tax would have reduced such tax to an amount ($0) equal to the actual regular tax liability ($0), B received a tax benefit from none of the $8.4 million of tax preferences and therefore all of these preferences are non-beneficial preferences.

(iii) Since B has $8.4 million in total preference items and no regular tax liability, the minimum tax on that amount would be $1,258,500 (($8.4 million minus $10,000) multiplied by .15). None of the preference items is a beneficial preference. Thus, the minimum tax attributable to nonbeneficial preferences (and therefore, the credit reduction amount is $1,258,500.

(iv) All of the $3.9 million of freed-up credits are foreign tax credits that arise in the same year and that otherwise would be carried forward. Since the entire amount of B's tax preferences are non-beneficial preferences, the minimum tax of $1,258,500 that would be imposed on the total tax preferences is the credit reduction amount. Thus, B's $3.9 million of freed-up foreign tax credits is reduced by $1,258,500. The foreign tax credit carryforward from 1982 is $10,041,500. This amount is the sum of $2,641,500 (the freed-up foreign tax credit of $3,900,000, reduced by the credit reduction amount of $1,258,500), plus $7.4 million (the foreign tax credit that would have been carried over even if tax preference items had not been allowed).

However, if the taxpayer has more than one type of freed-up credit, or the taxpayer's freed-up credits are from more than one taxable year, then the credit reduction amount must be allocated under the exact method described in paragraph (c)(5)(ii) of this section, unless an election is made under paragraph (c)(5)(iii) of this section to use the simplified method.

(ii) *Exact method.* For each type of freed-up credits and for each taxable year within such type from which any such credits are earned, the amount of credit reduction shall be equal to the amount of minimum tax attributable to the non-beneficial preferences that freed up the credits for that type and taxable year. The amount of the credit reduction is computed by multiplying the amount of non-beneficial preferences which freed up credits for each type and taxable year by the minimum tax rate. For purposes of this computation, if the amount of the taxpayer's minimum tax exemption for the taxable year (as determined under section 56(a)) exceeds the amount of the taxpayer's beneficial preferences, such excess exemption shall reduce the amount of non-beneficial preferences to be multiplied by the minimum tax rate. The non-beneficial preferences shall be reduced by any such excess exemption in the same order in which the credits that were freed up by such preferences would have been allowed to offset tax. Thus, for example, any excess exemption shall first reduce non-beneficial preferences that freed up foreign tax credits. Any such excess exemption remaining after reducing non-beneficial preferences that freed up foreign tax credits to zero would then be used to reduce the non-beneficial preferences that freed up investment tax credits.

(iii) *Simplified method*—(A) *Description of method.* In lieu of the exact credit reduction method described in paragraph (c)(5)(ii) of this section, taxpayers may elect to use the simplified credit reduction method. Under the simplified credit reduction method, the amount of freed-up credits for each type of credit and for each taxable year in which such credit is earned is multiplied by a fraction. The numerator of the fraction is the total credit reduction amount as determined in paragraph (c)(4)(i)(C) of this section. The denominator is the total amount of freed-up credits as determined in paragraph (c)(2)(i) of this section. The product of this multiplication is the amount of credit reduction for each type and taxable year of freed-up credit.

(B) *Election to use simplified method.* A taxpayer may elect to use the simplified credit reduction method for all taxable years to which this section applies by attaching a statement indicating such an election on the amended Federal income tax return or returns applying the adjustments of this section. If an election is made for any taxable year, it must be made for all taxable years. Once an election has been made, it can be revoked only with the permission of the Commissioner. Similarly, once returns have been filed applying the exact credit reduction method, an election to apply the simplified method can be made only with the consent of the Commissioner.

(iv) *Effect of credit reduction on credit carryovers.* Under both the exact method and the simplified method, the determination of credit carryovers to other taxable years is made on the basis of freed-up credits remaining after such reduction, plus any other unused credits. Thus, an amount of freed-up credits that is equal to the credit reduction amount shall not be allowed to reduce tax liability in any taxable year. Such disallowance is without regard to whether such credits would otherwise be allowed as a carryover. The freed-up credits, as reduced under this paragraph (c)(5), shall be carried over or carried back in applying this section in a carryover or carryback year. No minimum tax liability shall be due with respect to the non-beneficial preferences for any taxable year.

(v) *Examples.* The following examples illustrate reduction of freed-up credits.

Example 1. (i) Corporation L has the following items for the 1985 taxable year:

Actual taxable income		$90,000
Regular tax		21,750
Available credits:		
Foreign tax credits for 1985	$15,000	
Foreign tax credits carried forward from 1984	25,000	
Investment tax credits carried forward from 1984	20,000	
		60,000
Credit allowed to offset actual regular tax:		
Foreign tax credits for 1985	$15,000	
Foreign tax credits carried forward from 1984	6,750	
		21,750
Actual regular tax liability		21,750
Preferences		110,000
Taxable income for 1985 determined as though preferences were not allowed		200,000
Non-preference regular tax		71,750
Credits allowed to offset non-preference regular tax:		
Foreign tax credits for 1985	$15,000	
Foreign tax credits carried forward from 1984	$25,000	
Investment tax credits carried forward from 1984	20,000	
		60,000
Non-preference regular tax liability		11,750

(ii) The freed-up credits for 1985 are $38,250 ($60,000 minus $21,750). The non-preference regular tax is $71,750. The amount of L's non-beneficial preferences for the 1985 taxable year is $84.456.

(iii) The credit reduction amount for 1985 is $12,668, the amount of minimum tax attributable to L's non-beneficial preferences. This amount is allocated to reduce each category of freed-up credit and to each year from which such credit is carried over. L's $38,250 of freed-up credits consists of $18,250 of foreign tax credits carried forward from 1984, which were freed up by $40,978 of non-beneficial preferences, and $20,000 of investment tax credits carried forward from 1984, which were freed up by $43,478 of non-beneficial preferences.

(iv) The apportionment of this credit reduction amount to each category of freed-up credit and each taxable year from which such credits are carried over is determined as follows under the exact credit reduction method:

(A) Foreign tax credits carried forward from 1984:

Non-beneficial preferences that freed up 1984 FTC $\times$ .15 = Credit reduction of 1984 FTC

$40,978 $\times$ .15 = $6,146

(B) Investment tax credits carried forward from 1984:

Non-beneficial preferences that freed up 1984 ITC × .15 = Credit reduction of 1984 ITC

$43,478 × .15 = $6,522

Thus, the foreign tax credits from 1984 that are carried forward to 1986 are $12,104 ($18,250 minus $6,146). The investment tax credits from 1984 that are carried forward to 1986 are $13,478 ($20,000 minus $6,522).

(v) The reduction of the freed-up credit under the simplified credit reduction method is as follows:

(A) Foreign tax credit carried forward from 1984:

$$\begin{gathered}\text{Freed-up foreign tax} \\ \text{credits from 1984}\end{gathered} \times \frac{\text{Credit reduction amount}}{\text{Total freed-up credit}} = \begin{gathered}\text{Credit reduction allocated to} \\ \text{freed-up foreign tax credits} \\ \text{carried forward from 1984}\end{gathered}$$

$$\$18{,}250 \times \frac{\$12{,}668}{\$38{,}250} = \$6{,}044$$

(B) Investment tax credits carried forward from 1984:

$$\begin{gathered}\text{Freed-up investment tax} \\ \text{credits from 1984}\end{gathered} \times \frac{\text{Credit reduction amount}}{\text{Total freed-up credit}} = \begin{gathered}\text{Credit reduction allocated to} \\ \text{freed-up investment tax credit} \\ \text{carried forward from 1984}\end{gathered}$$

$$\$20{,}000 \times \frac{\$12{,}668}{\$38{,}250} = \$6{,}624$$

Thus, under the simplified credit reduction method, L has $12,206 of foreign tax credits for 1984 ($18,250 minus $6,044) that are carried forward to 1986, and $13,376 of investment tax credits for 1984 ($20,000 minus $6,624) that are carried forward to 1986.

Example 2. Assume the same facts as in *Example 1* of this paragraph (c)(5)(v), except that the foreign tax credits available for use in 1985 include $10,750 in credits carried forward from 1980 and $14,250 in credits carried forward from 1984, rather than $25,000 carried forward from 1984. Thus, $4,000 of the freed-up foreign tax credit is carried over from 1980. The other $14,250 of freed-up foreign tax credit is carried over from 1984. The non-beneficial preferences that freed up the 1980 foreign tax credit are $10,000. The non-beneficial preferences that freed up the 1984 foreign tax credit are $30,978. Under the exact credit reduction method, the credit reduction amounts for each of these credits are determined as follows:

(i) Foreign tax credit carried forward from 1980:

$10,000 × .15 = $1,500

(ii) Foreign tax credit carried forward from 1984:

$30,978 × .15 = $4,646

Thus, the foreign tax credit from 1984 that is carried forward to 1986 is $9,604 ($14,250 minus $4,646). Since the foreign tax credit from 1980 expires after 1985, none of that credit is carried forward to 1986.

(d) *Examples.* The following examples are comprehensive illustrations of the adjustments described in paragraph (c) of this section:

Example 1. (i) This example illustrates the operation of the credit reduction adjustment when the amount of foreign tax credit allowed is subject to the overall limitation under section 904. For purposes of this example, assume that Corporation × has the following items for the 1984 taxable year:

Taxable income (determined as though preferences were not allowed)	$140,000
From foreign sources	70,000
Foreign tax credits from 1984	5,000
Foreign tax credits from 1983	7,000
Actual taxable income	50,000
From foreign sources	25,000

(ii) The credit reduction adjustment and minimum tax liability for the taxable year are determined as follows:

1. Taxable income (determined as though preferences were not allowed)			$140,000
2. Tax preferences for 1984			90,000
3. Taxable income (line 1 minus line 2)			50,000

4. Regular tax on line 3 amount (actual regular tax) before credits: $25,000 × .15 = $3,750 25,000 × .18 = 4,500			8,250
5. Foreign tax credits allowed against regular tax (limited to 50% of actual regular tax under sec. 904)—1984 foreign tax credits			4,125
6. Regular tax after credits (line 4 minus line 5)			4,125
7. Regular tax on line 1 amount (non-preference regular tax) before credits 25,000 × .15 = $3,750. 25,000 × .18 = 4,500. 25,000 × .3 = 7,500. 25,000 × .4 = 10,000. 40,000 × .46 = 18,400			44,150
8. Foreign tax credits allowed against non-preference regular tax: $5,000 (1984 foreign tax credits) 7,000 (1983 foreign tax credits) (the allowed credits do not exceed the section 904 limitation of $22,075)			12,000
9. Non-preference regular tax after credits (line 7 minus line 8)			32,150
10. Freed-up credits (line 8 minus line 5):			
1984 foreign tax credits	$5,000 (4,125)		
		$875	
1983 foreign tax credits	$7,000 0		
		7,000	
Total		$7,875	

11. Non-beneficial preferences are computed as set forth in the table below. Under this computation, non-beneficial preferences are considered to free up credits that would have offset non-preference regular tax beginning at the lowest tax rates at which income that was offset by tax preferences otherwise would have been subjet to regular tax. In this case, income that was offset by tax preferences would have been taxed beginning at the 30 per cent marginal tax rate.

Type	Freed-up credit	Divided by tax rate	Non-beneficial preferences
FTC (84)	$875	.30	$2,917
FTC (83)	6,625	.30	22,083
Do	375	.40	938
	7,875		25,938
Total non-beneficial preferences			25,938

12. Beneficial preferences (line 2 minus line 11)	64,062
13. Minimum tax on total tax preferences ((line 2 minus the greater of line 6 or $10,000) × .15)	12,000
14. Minimum tax on beneficial preferences ((line 12 minus the greater of line 6 or $10,000) × .15)	8,109
15. Credit reduction amount (line 13 minus line 14)	3,891
16. Reduction of freed-up credits under the exact method (subtotals of line 11 multiplied by .15):	
(a) 1984 foreign tax credits: $2,917 × .15 = $438	
(b) 1983 foreign tax credits: ($22,083 + $938) × .15 = $3,453	
(c) Total credit reduction	3,891

Note: If X had elected to use the simplified credit reduction method, the amount of credit reduction would be determined by multiplying the amount of freed-up credit in each category and taxable year by the following ratio:

$$\frac{\text{credit reduction amount}}{\text{total freed-up credit}} = \frac{\$3,891}{\$7,875} = .494$$

(d) Under this method, the 1984 freed-up foreign tax credits would be reduced by $433 ($875 × .494)and the 1983 freed-up foreign tax credits would be reduced by $3,458 ($7,000 × .494).

17. Freed-up credits after reduction under the exact method (line 10 subtotal minus line 16 subtotals):	
(a) 1984 foreign tax credits ($874 minus $438)	437
(b) 1983 foreign tax credits ($7,000 minus $3,453)	3,547

Thus, assuming that Corporation X did not elect to use the simplified method, Corporation X will carryover $437 of 1984 foreign tax credits to 1985 and $3,547 of 1983 foreign tax credits to 1985. Had Corporation X elected to use the simplified method, freed-up credits after reduction would be as follows:

(a) 1984 foreign tax credits ($875 minus $433)	442
(b) 1983 foreign tax credits ($7,000 minus $3,458)	3,542

Example 2. (i) Corporation X has the following items for its 1985 taxable year:

Taxable income (determined as though preferences were not allowed)	$1,500,000
1984 investment tax credits	400,000
1985 investment tax credits	100,000
Actual taxable income	1,000,000

(ii) The credit reduction and minimum tax of X for 1985 are determined as follows:

1. Taxable income determined as though	$1,500,000
2. Tax preferences for 1985	500,000
3. Taxable income (line 1 minus line 2)	1,000,000
4. Regular tax on line 3 amount (actual regular tax) before credits:.	

$25,000 × .15 = $3,750 25,000 × .18 = 4,500 25,000 × .30 = 7,500 25,000 × .40 = 10,000 900,000 × .46 = 414,000	439,750
5. Investment tax credits allowed (limited under section 38 (c) to $25,000 of net tax liability, plus 85 percent of net tax liability in excess of $25,000	377,537
6. Regular tax after credits (line 4 minus line 5)	62,212
7. Regular tax on line 1 amount (non-preference regular tax) before credits: 25,000 × .15 = $3,750 25,000 × .18 = 4,500 25,000 × .30 = 7,500 25,000 × .40 = 10,000 900,000 × .46 = 414,000 405,000 × .51 = 206,550 95,000 × .46 = 43,700	690,000
8. Investment tax credits allowed against non-preference regular tax	500,000
9. Non-preference regular tax after credits (line 7 minus line 8)	190,000
10. Freed-up credits (line 8 minus line 5):	
1984 investment tax credit	$400,000 (377,537)
	22,463
1985 investment tax credit	$100,000 —0—
	100,000
Total	$122,463

11. Non-beneficial preferences are computed as set forth in the table below. Under this computation, non-beneficial preferences are considered to free up credits that would have offset non-preference regular tax beginning at the lowest tax rates at which income that was offset by tax preferences otherwise would have been subject to regular tax. In this case, income that was offset by tax preferences would have been taxed beginning at the 51 percent marginal tax rate. Although some of the income offset by preferences would be taxed at the 46 percent marginal rate (because taxable income in excess of $1,405,000 is not subject to the 5 percent addition to tax on taxable income in excess of $1 million), the 51 percent marginal rate is taken into account first.

Type	Freed-up credit	Divided by tax rate	Non-beneficial preferences
ITC (84)	$22,463	.51	$44,045
ITC (85)	100,000	.51	196,078
	122,463		240,123
Total non-beneficial preferences			240,123

12. Beneficial preferences (line 2 minus line 11)	259,877
13. Minimum tax on total tax preferences ((line 2 minus the greater of line 6 or $10,000) × .15)	65,668
14. Minimum tax on beneficial preferences ((line 12 minus the greater of line 6 or $10,000) × .15	29,650
15. Credit reduction amount (line 13 minus line 14)	36,018
16. Reduction of freed-up credits under the exact method (subtotals of line 11 multiplied by .15):	
(a) 1984 investment tax credits: $44,045 × .15 = $6,607	
(b) 1985 investment tax credits: $196,078 × .15 = $29,411	
(c) Total credit reduction	36,018
17. Fixed-up credits after reduction (assuming that Corporation X does not elect the simplified method):	
(a) 1984 investment credit ($22,463 minus $6,607)	15,856
(b) 1985 investment credit ($100,000 minus $29,411)	70,589

(e) *Miscellaneous rules*—(1) *Investment Credit Recapture*. If during any taxable year property to which section 47 applies is disposed of, then for purposes of determining any increase in tax under section 47 for such year, the amount of any reduction under this section of freed-up section 38 credit which was earned in the year the property was placed in service shall be treated as a credit that was allowed in a prior taxable year.

Example. Corporation D places property in service in 1983 that generates investment tax credits of $10,000. D earns no other investment tax credits in 1983. None of the investment tax credits are used to reduce tax liability in 1983 or any prior years. In 1984, D uses $1,000 of this credit to reduce regular tax liability. In addition, D has items of tax preferences in 1984. However, under section 58(h), D is not liable for minimum tax on any of these preference items because none of these preference items produces a tax benefit in 1984. As a result, an adjustment is made under the provisions of §1.58-9 and the investment tax credit carryforward from 1983 is reduced by $4,000. Thus, D has an investment tax credit carryforward of $5,000 that is attributable to the property placed in service in 1983. In 1986, the property is disposed of and the investment tax credits earned in 1983 are recomputed as required under section 47. This recomputation results in a reduction of $6,000 of the investment tax credits earned in 1983. D must now adjust its 1983 investment tax credit carryforward under section 47(a)(6) by reducing this carryforward to zero. In addition, D has an additional tax liability of $1,000 for 1986.

(2) *Period of limitations; adjustments to tax liability*. The adjustments described in this section shall, in general, apply for purposes of assessing deficiencies or claiming refunds of tax for any taxable

year for which the tax liability is affected by the adjustments of this section, provided that the period of limitations under section 6501 has not expired for such taxable year. Therefore, these adjustments generally apply for purposes of assessing deficiencies and refunding any overpayment of tax for all years for which the period of limitations has not expired regardless of whether the period of limitations has expired for the taxable year in which the non-beneficial preferences arose. However, the adjustments of this section do not apply to reduce otherwise allowable credits that were freed up by such non-beneficial preferences where:

(i) The taxpayer paid minimum tax on all tax preference items arising in the taxable year in which the non-beneficial preferences arose;

(ii) The taxpayer has not made a claim for a credit or refund for such minimum tax; and

(iii) The period of limitations for claiming a credit or refund under section 6511 has expired for such taxable year.

(A) Further, if—

(*1*) the taxpayer never paid minimum tax attributable to non-beneficial preferences;

(*2*) credits that were freed up by such preferences were used to reduce tax liability for a taxable year for which the period of limitations has expired; and

(*3*) credits so used exceed the amount of credits that would have been available if the credit reduction required under this section with respect to such preferences had been made,

(B) Then, the taxpayer shall be liable for the minimum tax equal to the amount of credits so used, provided the period of limitations has not expired for the taxable year in which preferences arose.

(3) *Claims for credit or refund.* A taxpayer may claim a credit or refund of minimum tax that was made on non-beneficial preferences. However, such a claim for a credit or refund shall be disallowed to the extent that the taxpayer has reduced tax liability in a taxable year for which the period of limitations has expired by using freed-up credits in excess of the amount that would have been available if the credit reduction required under this section had been made. Such claim must be made by filing an amended return for the taxable year for which such minimum tax was paid. Further, if a claim for credit or refund is filed, amended returns must also be filed for any taxable year for which tax liability would be affected as a result of the reduction, under this section, of credits freed up by such non-beneficial preferences. See section 6511 and the regulations thereunder regarding the period of limitations for claiming a credit or refund.

(4) *Carryovers of foreign tax credit to taxable years after 1986.* In the case of foreign tax credit carryforwards to taxable years beginning after December 31, 1986, reductions in such credits required under this section shall apply for purposes of computing the alternative minimum tax foreign tax credit under section 59(a) of the Internal Revenue Code of 1986 as well as for purposes of computing the foreign tax credit for regular tax purposes.

(5) *Credit Carrybacks.* If credit carrybacks increase the amount of credits for a taxable year, the adjustments described in this section shall be recomputed taking into account the additional credits. This rule may be illustrated by the following examples:

Example 1. (i) In 1981 corporation D has actual taxable income of $72,500 and regular tax before credits of $15,000. In computing actual regular taxable income, D made use of $36,739 of tax preference items, so that D's taxable income determined as though preference were not allowed would be $109,239. D's non-preference regular tax before credits is $30,000. D earns $25,000 of foreign tax credits in 1981, none of which exceed the limitation under section 904 determined using either actual regular taxable income or the non-preference taxable income. These credits reduce actual regular tax to zero ($0) and would have reduced non-preference regular tax to $5,000 ($30,000 minus $25,000). Thus, D has freed-up foreign tax credits from 1981 of $10,000 ($25,000 minus $15,000). Pursuant to the adjustments required under this section, D determines that its credit reduction amount is $3,843 and reduces its freed-up credit (and its credit carryover) from 1981 to $6,157 ($10,000 minus $3,843). D also pays minimum tax of $167 on $11,114 of beneficial preferences (($11,114 minus $10,000) multiplied by .15).

(ii) In 1982 D earns additional foreign tax credits. After application of the foreign tax credit carryback rules, D would have $5,000 of 1982 foreign tax credits available for use in

1981. D must recalculate the adjustments required under this section by treating $5,000 of foreign tax credit from 1982 as carried back and (assuming that these credits do not exceed the limitation under section 904) used to reduce non-preference regular tax liability in 1981 to zero ($0). That is, $5,000 of the foreign tax credits earned in 1982 are treated as credits freed up because of D's tax preference items in 1981. Pursuant to the rules set forth herein, D must take into account the foreign tax credits from both 1981 and 1982 in determining to what extent a tax benefit was derived from the preference items used to determine actual regular tax liability in 1981 and in computing the credit reduction amount. When the $5,000 of foreign tax credits from 1982 are considered, all preferences become non-beneficial preferences, and the credit reduction amount is $4,010. Assuming that D elects the simplified method, the 1981 freed-up credits and the 1982 freed-up credits will each be reduced by the following percentage:

$$\frac{\$4{,}010\ (\text{credit reduction amount})}{\$15{,}000\ (\text{total freed-up credits})} = .2673$$

The 1981 freed-up foreign tax credits of $10,000 are thus reduced by $2,673 ($10,000 multiplied by .2673), to $7,327 and the 1982 freed-up foreign tax credits of $5,000 are reduced by $1,334 ($5,000 multiplied by .2673) to $3,666. D also files a claim for credit or refund of the $167 of minimum tax paid in 1981.

Example 2. In 1985 corporation E's non-preference regular taxable income was $25,000. E had no available credits. It paid zero in regular tax, however, because of $25,000 in preference items. E paid $2,250 of minimum tax on these preferences (($25,000 minus $10,000) multiplied by .15). In 1986, E has additional investment tax credits. After application of the investment tax credit carryback rules, E would have $1,000 investment tax credit from 1986 available for use in 1985. E must recompute the adjustments required under this section by treating $1,000 of these 1986 investment tax credits as carried back and used to reduce non-preference regular tax liability for 1985. Pursuant to the rules of this section, all of these $1,000 of credits are freed-up credits. Non-beneficial preferences are $6,667 ($1,000 grossed up at a 15 percent regular tax rate). Beneficial preferences are $18,333 ($25,000 minus $6,667). Minimum tax on all preferences would be $2,250 (($25,000 minus $10,000) multiplied by .15); minimum tax on beneficial preferences would be $1,250 (($18,333 minus $10,000) multiplied by .15). Minimum tax attributable to the non-beneficial preferences is thus $1,000 ($2,250 minus $1,250), which is the credit reduction amount. E thus reduces the $1,000 of credits carried back to 1985 to zero. Under the rules of this section, the amount of minimum tax due for 1985 is redetermined. It is equal to the minimum tax on beneficial preferences, which, as described above, is $1,250. Because E paid minimum tax of $2,250 in 1985, E files a claim for credit or refund for $1,000 of the minimum tax paid in 1985.

(f) *Treatment of net operating losses.* [Reserved]

[T.D. 8416, 57 FR 19255, May 5, 1992; 57 FR 24848, June 11, 1992]

§ 1.59–1 Optional 10-year writeoff of certain tax preferences.

(a) *In general.* Section 59(e) allows any qualified expenditure to which an election under section 59(e) applies to be deducted ratably over the 10-year period (3-year period in the case of circulation expenditures described in section 173) beginning with the taxable year in which the expenditure was made (or, in the case of intangible drilling and development costs deductible under section 263(c), over the 60-month period beginning with the month in which the expenditure was paid or incurred).

(b) *Election*—(1) *Time and manner of election.* An election under section 59(e) shall only be made by attaching a statement to the taxpayer's income tax return (or amended return) for the taxable year in which the amortization of the qualified expenditures subject to the section 59(e) election begins. The statement must be filed no later than the date prescribed by law for filing the taxpayer's original income tax return (including any extensions of time) for the taxable year in which the amortization of the qualified expenditures subject to the section 59(e) election begins. Additionally, the statement must include the following information—

(i) The taxpayer's name, address, and taxpayer identification number; and

(ii) The type and amount of qualified expenditures identified in section 59(e)(2) that the taxpayer elects to deduct ratably over the applicable period described in section 59(e)(1).

(2) *Elected amount.* A taxpayer may make an election under section 59(e) with respect to any portion of any qualified expenditure paid or incurred by the taxpayer in the taxable year to which the election applies. An election under section 59(e) must be for a specific dollar amount and the amount

subject to an election under section 59(e) may not be made by reference to a formula. The amount elected under section 59(e) is properly chargeable to a capital account under section 1016(a)(20), relating to adjustments to basis of property.

(c) *Revocation*—(1) *In general.* An election under section 59(e) may be revoked only with the consent of the Commissioner. Such consent will only be granted in rare and unusual circumstances. The revocation, if granted, will be effective in the first taxable year in which the section 59(e) election was applicable. However, if the period of limitations for the first taxable year the section 59(e) election was applicable has expired, the revocation, if granted, will be effective in the earliest taxable year for which the period of limitations has not expired.

(2) *Time and manner for requesting consent.* A taxpayer requesting the Commissioner's consent to revoke a section 59(e) election must submit the request prior to the end of the taxable year the applicable amortization period described in section 59(e)(1) ends. The application for consent to revoke the election must be submitted to the Internal Revenue Service in the form of a letter ruling request.

(3) *Information to be provided.* A request to revoke a section 59(e) election must contain all of the information necessary to demonstrate the rare and unusual circumstances that would justify granting revocation.

(4) *Treatment of unamortized costs.* The unamortized balance of the qualified expenditures subject to the revoked section 59(e) election as of the first day of the taxable year the revocation is effective is deductible in the year the revocation is effective (subject to the requirements of any other provision under the Code, regulations, or any other published guidance) and the taxpayer will be required to amend any federal income tax returns affected by the revocation.

(d) *Effective date.* These regulations apply to a section 59(e) election made for a taxable year ending, or a request to revoke a section 59(e) election submitted, on or after December 22, 2004.

[T.D. 9168, 69 FR 76616, Dec. 22, 2004]

§ 1.60 [Reserved]

FINDING AIDS

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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.*

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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
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
1.506–1T	1545–2268
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

CFR part or section where identified and described	Current OMB control No.
1.585–1	1545–0123
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

CFR part or section where identified and described	Current OMB control No.
	1545–1004
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
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

CFR part or section where identified and described	Current OMB control No.
1.955–3	1545–0123
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
1.987–1	1545–2265
1.987–3	1545–2265
1.987–9	1545–2265
1.987–10	1545–2265
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
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

CFR part or section where identified and described	Current OMB control No.
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
	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

CFR part or section where identified and described	Current OMB control No.
1.1561–3	1545–0123
1.1563–1	1545–0123
	1545–0797
	1545–2019
1.1563–3	1545–0123
1.5000A–3	1545–0074
1.5000A–4	1545–0074
1.5000C–2	1545–0096
	1545–2263
1.5000C–3	1545–0096
	1545–2263
1.5000C–4	1545–1223
	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

CFR part or section where identified and described	Current OMB control No.
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
	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

CFR part or section where identified and described	Current OMB control No.
	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
	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

CFR part or section where identified and described	Current OMB control No.
	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
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
1.6696–1	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

CFR part or section where identified and described	Current OMB control No.
	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
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

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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
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

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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
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

CFR part or section where identified and described	Current OMB control No.
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

CFR part or section where identified and described	Current OMB control No.
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
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
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

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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
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
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